14-400

No.

IN THE

Supreme Court of the United States

CHARLES E. HARRIS, III,

Petitioner,

v.

MARY K. VIEGELAHN, CHAPTER 13 TRUSTEE,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

J. TODD MALAISE
STEVEN G. CENNAMO
MALAISE LAW FIRM
909 N.E. LOOP 410, STE. 300
SAN ANTONIO, TEXAS
(210) 732-6699

MARK T. STANCIL
Counsel of Record
ALAN E. UNTEREINER
MATTHEW M. MADDEN
ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP
1801 K STREET, N.W., STE. 411L
WASHINGTON, D.C. 20006
(202) 775-4500
mstancil@robbinsrussell.com

QUESTION PRESENTED

Chapter 13 of the Bankruptcy Code allows debtors to repay their creditors by turning a portion of their monthly income over to a Chapter 13 trustee for distribution to those creditors. At any time, however, a debtor may convert a Chapter 13 bankruptcy case to one under Chapter 7. Congress has provided that "[e]xcept" where the conversion is made in bad faith, the resulting Chapter 7 estate is limited to the debtor's property "as of the date" the original Chapter 13 petition was filed; it does not include wages or property that the debtor acquired *after* the petition date. 11 U.S.C. § 348(f).

The question presented is:

Whether, when a debtor in good faith converts a bankruptcy case to Chapter 7 after confirmation of a Chapter 13 plan, undistributed funds held by the Chapter 13 trustee are refunded to the debtor (as the Third Circuit held in *In re Michael*, 699 F.3d 305 (2012)) or distributed to creditors (as the Fifth Circuit held below).

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF AUTHORITIES iii

OPINIONS BELOW 1

JURISDICTION 1

STATUTORY PROVISIONS INVOLVED 1

STATEMENT 2

A. The Bankruptcy Court Proceedings 4

B. The District Court's Decision 6

C. The Court of Appeals' Decision 9

REASONS FOR GRANTING THE PETITION 10

I. The Court Of Appeals' Decision Conflicts With The Third Circuit And Deepens The Widespread Division Among Lower Courts 10

II. The Decision Below Is Erroneous 19

III. The Issue Is Recurring And Important To The Administration Of Chapter 13 28

CONCLUSION 31

TABLE OF AUTHORITIES

Page(s)

Cases

Arkison v. *Plata (In re Plata)*,
958 F.2d 918 (9th Cir. 1992) 14, 23, 24

Chase v. *Winnecour (In re Chase)*,
No. 03-10092, 2008 WL 2309529
(Bankr. W.D. Pa. June 4, 2008) 17

DeHart v. *Michael (In re Michael)*,
446 B.R. 665 (M.D. Pa. 2011) 17

Gallagher v. *Dockery (In re Gallagher)*,
No. CC-13-1368-TaKuPa, 2014 WL 998411
(B.A.P. 9th Cir. Mar. 17, 2014) 17

In re Bell, 248 B.R. 236
(Bankr. W.D.N.Y. 2000) 17

In re Bobroff, 766 F.2d 797
(3d Cir. 1985) 8

In re Boggs, 137 B.R. 408
(Bankr. W.D. Wash. 1992) 9, 15, 17

In re Bullock, 41 B.R. 637
(Bankr. E.D. Pa 1984) 17

In re Galloway, 134 B.R. 602
(Bankr. W.D. Ky. 1991) 17

In re Halpenny, 125 B.R. 814
(Bankr. D. Haw. 1991) 17

In re Hardin, 200 B.R. 312
(Bankr. E.D. Ky. 1996) 17

TABLE OF AUTHORITIES—CONTINUED

Page(s)

In re Horne, No. 97-20171, 2002 WL 33939743 (Bankr. D. Idaho Jan. 10, 2002) 14, 17

In re Krahenbuhl, No. 09-29618-svk, 2013 WL 3793405 (Bank. E.D. Wisc. July 19, 2013).....17

In re Markham, 504 B.R. 1 (Bankr. D. Mass. 2013) 17

In re Michael, 436 B.R. 323 (Bankr. M.D. Pa. 2010) 17

In re Michael, 699 F.3d 305 (3d Cir. 2012).....*passim*

In re Milledge, 94 B.R. 218 (Bankr. M.D. Ga. 1988).....17

In re Murphy, Nos. 09-81861, 12-30813, 2014 WL 2600168 (Bankr. M.D. Ala. Feb. 11, 2014) 17

In re Parrish, 275 B.R. 424 (Bankr. D.D.C. 2002) 13, 21

In re Pegues, 266 B.R. 328 (Bankr. D. Md. 2001) 17

In re Redick, 81 B.R. 881 (Bankr. E.D. Mich. 1987).....18

In re Salisbury, No. 99-10431C-7G, 2000 WL 33673758 (Bankr. M.D.N.C. Nov. 17, 2000) 17

In re Smith, 511 B.R. 612 (Bankr. W.D. Mo. 2014) 17

Ledford v. *Burns (In re Burns)*, 90 B.R. 301 (Bankr. S.D. Ohio 1988).....17

TABLE OF AUTHORITIES—CONTINUED

Page(s)

O'Quinn v. *Brewer (In re O'Quinn)*, 143 B.R. 408 (Bankr. S.D. Miss. 1992) 17

Spero v. *Porreco (In re Porreco)*, 426 B.R. 529 (Bankr. W.D. Pa. 2010) 17

United Sav. Ass'n of Tex. v. *Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988) 23

Waugh v. *Saldamarco (In re Waugh)*, 82 B.R. 394 (Bankr. W.D. Pa. 1988) 17

Constitutional Provision, Statutes, and Rules

U.S. Const., art. 1, § 8, cl. 4 30

11 U.S.C. § 348 1

11 U.S.C. § 348(e) ..... *passim*

11 U.S.C. § 348(f) 5, 12, 19, 20

11 U.S.C. § 348(f)(1) 14

11 U.S.C. § 348(f)(1)(A) 3

11 U.S.C. § 348(f)(2) 8, 9, 12, 20

11 U.S.C. § 349(b)(3) 23, 24

11 U.S.C. § 522(b)(2) 6

11 U.S.C. § 541 ..... 5, 25

11 U.S.C. § 1227(b) 23

11 U.S.C. § 1306 ..... 5, 25

11 U.S.C. § 1306(a)(2) 22

11 U.S.C. § 1306(b) 23

TABLE OF AUTHORITIES—CONTINUED

Page(s)

11 U.S.C. § 1307(a) 1, 3

11 U.S.C. § 1326(a)(2) 23

11 U.S.C. § 1327(b) 2, 13, 22

28 U.S.C. § 1254(1) 1

Federal Rule of Bankruptcy Procedure 1019(5)(B)(ii) 13

Other Authorities

Admin. Office of the U.S. Courts, Table F-2, *U.S. Bankruptcy Courts—Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending June 30, 2014* 28, 29

H.R. Rep. No. 103-835 (1994) 20

Katherine Porter, *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, 90 Tex. L. Rev. 103 (2011) 28, 29

U.S. Dep't of Justice, Exec. Office for U.S. Trustees, *Handbook for Chapter 13 Standing Trustees* (Oct. 1, 2012) 30

PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the Fifth Circuit (App., *infra*, 1a–28a) is reported at 757 F.3d 468. The district court's decision (App., *infra*, 29a–49a) is reported at 491 B.R. 866. The bankruptcy court's opinion (App., *infra*, 50a–51a) is unreported.

JURISDICTION

The Fifth Circuit issued its decision on July 7, 2014. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

In pertinent part, 11 U.S.C. § 1307(a) provides:

> The debtor may convert a case under this chapter to a case under chapter 7 of this title at any time.

In pertinent part, 11 U.S.C. § 348 provides:

> (e) Conversion of a case under section 706, 1112, 1208, or 1307 of this title terminates the service of any trustee or examiner that is serving in the case before such conversion.
>
> (f)(1) Except as provided in paragraph (2), when a case under chapter 13 of this title is converted to a case under another chapter under this title—
>
> (A) property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the

possession of or is under the control of the debtor on the date of conversion;

* * * * *

(2) If the debtor converts a case under chapter 13 of this title to a case under another chapter under this title in bad faith, the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion.

11 U.S.C. § 1327(b) provides:

Except as otherwise provided in the plan or the order confirming the [chapter 13] plan, the confirmation of a plan vests all of the property of the estate in the debtor.

STATEMENT

This case presents an opportunity to resolve a recurring and important question of bankruptcy law that has "divided courts for thirty years" (App., *infra*, 2a) and on which two courts of appeals are now in acknowledged disagreement. This persistent division concerns whether a debtor is entitled to funds held by a trustee pursuant to a confirmed Chapter 13 plan when a debtor exercises his right to convert his bankruptcy case to a proceeding under Chapter 7. In the decision below, the Fifth Circuit required those funds to be distributed to petitioner's creditors (*id.* at 1a–28a); in contrast, the Third Circuit requires the return of such funds to the debtor (*In re Michael*, 699 F.3d 305 (2012)).

Under Chapter 7, creditors are paid out of the debtor's *pre-petition* assets (and *only* those assets). Under Chapter 13, by contrast, the debtor's estate

includes his *post-petition* income, which is most often what is used to pay his creditors. In exchange for a debtor's voluntary election to pay creditors in Chapter 13 out of his future income—funds that would be off-limits in a Chapter 7 proceeding—a Chapter 13 plan generally allows the debtor to continue to possess and use pre-petition assets that he might otherwise have to relinquish to creditors (such as a house or an automobile). "The Chapter 13 bankruptcy tends to be favored by debtors who have fallen behind on secured loan payments, such as mortgages and car loans, since it enables the debtor to maintain possession of the property while catching up on payments through a court-approved re-payment plan." App., *infra*, 36a.

A debtor has the right to convert his bankruptcy proceeding from Chapter 13 to Chapter 7 "[a]t any time during the Chapter 13 proceeding." App., *infra*, 37a (citing 11 U.S.C. § 1307(a)). "[C]onversion from Chapter 13 to Chapter 7," the Fifth Circuit recognized, "'necessarily ends the Chapter 13 case, which also terminates that Chapter 13 estate.'" *Id.* at 18a (quoting *In re Michael*, 699 F.3d at 313)). In the absence of a showing that the conversion was done in bad faith, the converted case "is effectively backdated to the date on which the Chapter 13 petition was filed" and the "'property of the estate'" in Chapter 7 is that which existed "'*as of the date of filing of the [Chapter 13] petition.*'" *Id.* at 37a (quoting 11 U.S.C. § 348(f)(1)(A)) (emphasis and alteration in original).

The Fifth Circuit held that, notwithstanding such a good-faith conversion, a Chapter 13 trustee should distribute any funds in its possession to creditors. The Third Circuit, in contrast, has held

that such funds should be refunded to the debtor. In short, a debtor's "fresh start" in bankruptcy is routinely thousands of dollars fresher in the Third Circuit (and many bankruptcy courts) than it is in the Fifth Circuit (and many other bankruptcy courts).

This Court's guidance is needed to resolve that split and to provide uniformity in the administration of the Nation's bankruptcy laws. The issue presented is undeniably recurring and important: Each year approximately 320,000 Chapter 13 proceedings are initiated, of which 60,000 are eventually converted to Chapter 7. See *infra* pages 29–30. At the same time, the monetary stakes are often too small, or the resources of debtors too meager, to justify not only litigating the issue in bankruptcy court but also pursuing multiple appeals to the district court and the court of appeals, thus ensuring that the issue has rarely been presented for this Court's review. This case is an excellent vehicle for resolving this pure question of law.

A. The Bankruptcy Court Proceedings

In early 2010, Petitioner Charles E. Harris, III, fell $3,700 behind on his home mortgage. App., *infra*, 3a. As a result, he filed for relief under Chapter 13 of the Bankruptcy Code. *Ibid.* Harris proposed a payment plan under which he would resume paying his mortgage, and his mortgage arrears and other debts would be repaid in full over 60 months out of $530 garnished from his wages each month by Respondent Mary K. Viegelahn, the Chapter 13 Trustee. *Id.* at 3a–4a. The bankruptcy court confirmed that plan in April 2010. *Id.* at 30a.

Petitioner was not able to keep his mortgage current. Accordingly, in November 2010 his mortgagor received (without opposition from petitioner) relief from the automatic bankruptcy stay to begin foreclosure proceedings on petitioner's home. App., *infra*, 4a. At that point, as required by petitioner's confirmed Chapter 13 plan, respondent stopped distributing $372 of petitioner's monthly wages to his mortgagor because the mortgagor had been granted leave to seek repayment of petitioner's mortgage arrears through foreclosure. *Ibid.*

Having failed to save his home, petitioner filed a notice converting his case to Chapter 7 in November 2011. Section 1307(a) of the Bankruptcy Code entities a Chapter 13 debtor to convert his case to Chapter 7 "at any time." Whereas Chapter 13 provides for creditors to be paid out of a portion of the debtor's future wages, Chapter 7 provides for repayment from the liquidation of property interests held by the debtor on the date he filed his original bankruptcy petition (subject to certain statutory exceptions). Compare 11 U.S.C. § 541 with *id.* § 1306. Any property the debtor acquired *after* his original petition date (including his post-petition wages) is not property of the Chapter 7 estate once the debtor has made a good-faith conversion. *Id.* § 348(f). A conversion to Chapter 7 also automatically "terminates the service" of the Chapter 13 trustee. *Id.* § 348(e). It is undisputed that petitioner's conversion to Chapter 7 was done in good faith.

At the time of petitioner's conversion, and after petitioner had assigned some funds to pay his attorneys' fees, respondent held $4,319.22 of petitioner's post-petition garnished wages. App.,

infra, 5a. Notwithstanding the conversion of petitioner's case to Chapter 7, respondent distributed those post-petition wages to petitioner's creditors, instead of returning them to petitioner. Petitioner moved to compel the refund of that money as having been distributed without authority.

The bankruptcy court granted petitioner's motion, ordering respondent to refund to petitioner the money she had distributed to creditors after petitioner's conversion to Chapter 7. Respondent appealed, and the bankruptcy court stayed its order upon respondent's posting of a $10,000 bond.[1]

B. The District Court's Decision

The district court affirmed the bankruptcy court's refund order. App., *infra*, 29a–49a. The court "agree[d] with the Third Circuit's reasoning" in *In re Michael*, 699 F.3d 305 (2012), that "the funds in question must be returned to the debtor." App., *infra*, 34a. The court acknowledged the deep division among bankruptcy courts on that issue, and found "more persuasive" the reasoning of those courts that had agreed with the bankruptcy court's position—

---

[1] Petitioner's case thereafter proceeded under Chapter 7. With his home and mortgage out of the case, petitioner's only remaining assets were exempt from his estate under 11 U.S.C. § 522(b)(2). Accordingly, debtor's newly appointed Chapter 7 trustee reported to the court in December 2011 what had been true for months: Petitioner had "no property available for distribution from the estate over and above that exempted by law." On February 23, 2012, the bankruptcy court granted petitioner a discharge pursuant to Section 727 of the Bankruptcy Code.

"including, most recently, the Third Circuit." *Id.* at 43a

The district court reasoned that returning any undistributed funds to the debtor upon conversion was necessary to maximize a debtor's incentive to try to repay his creditors by proceeding under Chapter 13 in the first place. App., *infra*, 43a. The Bankruptcy Code, the court explained, implements a "Congressional policy of encouraging debtors to attempt a Chapter 13 bankruptcy—through which a debtor will pay his creditors at least as much and likely more than he would have under Chapter 7." *Ibid.* Such a policy can be achieved only if the debtor can convert to Chapter 7 "without penalty if that attempt fails." *Ibid.*

In fact, the court explained, the rule urged by the trustee "would create" a powerful reason for debtors to *avoid* Chapter 13 altogether—"precisely the kind of disincentive to file a Chapter 13 bankruptcy that Congress was trying to avoid." App., *infra*, 47a. A debtor's post-petition wages, the court noted, are not included in a Chapter 7 estate, and a debtor who elects to proceed under Chapter 7 from the start puts those funds beyond the reach of his creditors. But a debtor who chooses to put those funds *within reach* of his creditors in order to attempt to make a Chapter 13 plan work should not be penalized by the loss of more of those funds to his creditors after such a plan has proven unworkable. A Chapter 13 trustee's *post-conversion* disbursement to creditors of a debtor's post-petition wages, the court held, is antithetical to that policy. *Id.* at 43a–45a; see also *id.* at 45a ("'If debtors must take the risk that property acquired during the course of an attempt at

repayment will have to be liquidated for the benefit of creditors if chapter 13 proves unavailing, the incentive to give chapter 13—which must be voluntary—a try will be greatly diminished'" (quoting *In re Bobroff*, 766 F.2d 797, 803 (3d Cir. 1985)).

This case, the district court added, provides a telling illustration of the potential disincentives to using Chapter 13 that would arise if the funds in question were distributed to creditors rather than returned to the debtor:

> Here, Debtor attempted to repay his debts under Chapter 13, making payments under the confirmed plan for more than a year and a half. There is no dispute that the funds at issue would not have been part of the Chapter 7 estate if Debtor had filed a Chapter 7 petition originally; nor does the Trustee allege that Debtor converted to Chapter 7 in bad faith.

Id. at 47a–48a.

To whatever extent its holding might "incentivize bad-faith conversions" to "'game the system,'" the court stated that Section 348(f)(2) of Bankruptcy Code provided Congress's response. Under that provision, the result of a *bad-faith* conversion is that all debtor's property *on the date of conversion* (including any post-petition wages) is included in the "property of the estate" in the resulting Chapter 7 case. *Id.* at 47a. Indeed, the district court reasoned, Congress's answer to bad-faith conversions in Section 348(f)(2) "provides additional support for the idea that Congress would

want the disputed funds to be returned to [the] [d]ebtor" upon his good-faith conversion. *Ibid.*

Finally, the district court observed that there is "nothing unfair about returning [undistributed, post-petition wages] to a debtor rather than to his creditors." App., *infra*, 45a. During the pendency of the Chapter 13 case, creditors would already "'have had the benefit of distribution from debtors' wage contributions, which would not have been available to them under Chapter 7.'" *Id.* at 45a–46a (quoting *In re Boggs*, 137 B.R. 408, 410 (Bankr. W.D. Wash. 1992)). Given that creditors had already received value to which they were entitled only at the debtor's election, "'there seems no inherent inequity in refunding undisbursed wage contributions to debtors on conversion.'" *Id.* at 46a (same).

C. The Court of Appeals' Decision

Respondent appealed a second time, and the court of appeals reversed. The Fifth Circuit held that, notwithstanding petitioner's good-faith conversion to Chapter 7, his post-petition wages were appropriately distributed to his creditors under his Chapter 13 plan. The court of appeals recognized that this "question of law" is one that "has divided courts for thirty years." App., *infra*, 2a. In addition to the Third Circuit's contrary decision in *In re Michael*, the Fifth Circuit cited eight bankruptcy court "[o]pinions holding that the funds should be returned to the debtor," and twelve bankruptcy court "[o]pinions holding that the funds should be distributed to creditors." *Id.* at 2a n.1.

Unlike the Third Circuit, the Fifth Circuit found "little guidance in the Bankruptcy Code." App., *infra*,

22a. It turned instead "to considerations of equity and policy," and in doing so relied heavily on Judge Roth's dissent from the Third Circuit's *In re Michael* decision to conclude that such considerations favor creditors rather than debtors. See *id.* at 22a–28a.

Again acknowledging contrary decisions by the Third Circuit and numerous bankruptcy and district courts, the court of appeals concluded that, although "payments made under the plan do not give creditors any vested rights to payment, * * * the creditors' claim to the undistributed funds is superior to that of the debtor." App., *infra*, 28a.

REASONS FOR GRANTING THE PETITION

I. The Court Of Appeals' Decision Conflicts With The Third Circuit And Deepens The Widespread Division Among Lower Courts

The court of appeals acknowledged that its decision conflicts with the Third Circuit's decision in *In re Michael*, 699 F.3d 305 (2012), and that this issue "has divided courts for thirty years." App., *infra*, 2a. This Court should grant the petition in order to resolve that longstanding dispute and settle this important and recurring question of bankruptcy law.

A. The Third Circuit, presented with nearly identical facts in a case two years ago, reached the opposite conclusion from that reached by the court of appeals below. The Third Circuit held that "undistributed plan payments held by a Chapter 13 trustee at the time of conversion must be returned to the debtor absent bad faith." *In re Michael*, 699 F.3d at 316.

In *Michael*, as here, the debtor's Chapter 13 plan required regular mortgage payments outside the plan and monthly wage garnishments from which the Chapter 13 trustee would pay debtor's mortgage arrears and unsecured consumer debt. 699 F.3d at 307. After confirmation of the plan, the debtor again fell behind on his mortgage. *Ibid.* His mortgagor received relief from the automatic bankruptcy stay to foreclose on debtor's home. *Ibid.* The trustee tried to continue sending debtor's mortgagor the same portion of the monthly wage garnishments as before, but the mortgagor refused those payments because of its relief from the stay and commencement of foreclosure proceedings. *Ibid.* Having been unable to salvage his home by proceeding in Chapter 13, the debtor converted his case to Chapter 7 more than three years later.

By that time, the Chapter 13 trustee had accumulated nearly ten thousand dollars in debtor's post-petition wages because of the distributions refused by the mortgagor. 699 F.3d at 307. Both the bankruptcy court and the district court ordered the Chapter 13 trustee to return any undistributed funds, post-conversion, to the debtor. *Id.* at 307–08. The Third Circuit affirmed. In a majority opinion by Judge Ambro, the court held that, although "the Code provide[s] no clear answer to this question," *id.* at 308, a number of its provisions compel the conclusion that Congress intended for undistributed funds to be returned to the debtor, *id.* at 308–10. As explained below, the Fifth Circuit in this case expressly disagreed with each step in the Third Circuit's analysis.

First, the Third Circuit pointed to Section 348(f). 699 F.3d at 308. Section 348(f) states that funds held by a Chapter 13 trustee when a debtor converts his case to Chapter 7 do not become property of the Chapter 7 estate unless the conversion is made in bad faith. 11 U.S.C. § 348(f). Although Section 348(f) does not "resolve explicitly" whether those funds get returned to the debtor or distributed to his creditors, the Third Circuit concluded that "§ 348(f)'s language and legislative history express Congress's preference as to what property belongs to a debtor after conversion, and ultimately direct our decision." 699 F.3d at 308–09; see also *id.* at 314 (explaining that the history of Section 348(f) "supports that Congress's intended outcome is that payments held by the Chapter 13 trustee revert to the debtor on conversion"). The court further reasoned that "§ 348(f)(2) logically requires that a debtor receive the property if he acts in good faith" by providing that "a debtor who converts in bad faith is not entitled to this post-petition property." *Ibid.*

According to the Fifth Circuit, however, the Third Circuit "fail[ed] to recognize that undistributed post-petition wages * * * constitute only a subset of the debtor's post-petition property." App., *infra*, 21a. Therefore, in the Fifth Circuit's view, "distributing the remaining payments held by the trustee at the time of conversion neither renders § 348(f)(2) superfluous nor removes the disincentive for bad faith in most cases." *Id.* at 22a.

Second, the Third Circuit in *Michael* examined Section 348(e) of the Bankruptcy Code, which "'terminates the service[]' of the Chapter 13 trustee" when a case is converted to Chapter 7. 699 F.3d at

310 (quoting 11 U.S.C. § 348(e)). Termination of the trustee's service upon conversion, Judge Ambro explained, "seemingly renders [the trustee] powerless to make payments to creditors under a Chapter 13 plan." *Ibid.* The trustee retains certain ancillary duties, post-conversion, "to account for the funds that came into his possession by filing a final report under Federal Rule of Bankruptcy Procedure 1019(5)(B)(ii)," *ibid.*, but those "limited duties" do not imply "that he is permitted to distribute funds under a plan that is no longer operative," *id.* at 314.

The Fifth Circuit, by contrast, thought that the Third Circuit had taken the language of Section 348(e) "'too literally.'" App., *infra*, 10a (quoting *In re Parrish*, 275 B.R. 424, 430 (Bankr. D.D.C. 2002)). "'[T]here is no logical reason,'" the court believed, "'why distribution of funds pursuant to the previously confirmed reorganization plan cannot be included" among the Chapter 13 trustee's post-conversion "administrative duties." App., *infra*, 11a (quoting *In re Michael*, 699 F.3d at 320 n.8 (Roth, J., dissenting)).

Finally, the Third Circuit construed Section 1327(b) of the Bankruptcy Code as requiring the undistributed wages to be returned to the debtor. Section 1327(b) provides that confirmation of a Chapter 13 plan "vests all of the property of the estate in the debtor" "[e]xcept as otherwise provided in the plan or the order confirming the plan." 11 U.S.C. § 1327(b). "The implication" of that directive, the Third Circuit concluded, "is that property held by the Chapter 13 Trustee after plan confirmation is 'under the control of the debtor as of the date of [a

later] conversion' for purposes of § 348(f)(1)." 699 F.3d at 310 (alteration in original).

The Third Circuit also noted that the Ninth Circuit had reached the same conclusion by relying on Section 1327(b)'s counterpart in Chapter 12 of the Bankruptcy Code (which applies to family farmers and fishermen). *Ibid.* (citing *Arkison* v. *Plata (In re Plata)*, 958 F.2d 918, 922 (9th Cir. 1992)). In *Plata*, the Ninth Circuit relied on cases construing Chapter 13 to hold that "postconfirmation funds held by the Chapter 12 trustee but remaining unpaid to creditors at the time the Chapter 12 case was converted to a Chapter 7 liquidation revested in Debtors at the time of the conversion." 958 F.2d at 922. Where nothing in the confirmed Chapter 12 plan "either required or even provided for the later payment by the trustee of any undisbursed funds to creditors in the event of a conversion to Chapter 7," a debtor's vested rights in the property of the estate at plan confirmation controlled. *Ibid.*[2]

Once again, the Fifth Circuit rejected this analysis, concluding that it "ignor[ed] the clear exception to this general rule" for actions required by the confirmed plan. App., *infra*, 19a. As the Fifth Circuit viewed the statute, when a Chapter 13 plan calls for funds to be collected and distributed by a

---

[2] There is every reason to believe that the Ninth Circuit would reach the same conclusion with respect to a conversion from Chapter 13 to Chapter 7. At least one bankruptcy court in that Circuit has already concluded that *Plata* controls the same question under Chapter 13. *In re Horne*, No. 97-20171, 2002 WL 33939743, at *4 (Bankr. D. Idaho Jan. 10, 2002).

trustee, the plan excludes such funds from the "property of the estate" that "vests" "in the debtor." See *id.* at 18a–19a.

In addition to its statutory analysis, the Third Circuit concluded that policy considerations favor requiring Chapter 13 trustees to return undistributed funds to the debtor upon conversion. The Third Circuit sided with bankruptcy courts that have concluded there is "nothing 'unjust' in returning undistributed plan payments to a debtor." 699 F.3d at 312 (citing *In re Boggs*, 137 B.R. at 410). After all, the court explained, "creditors ultimately will receive as much, if not more, than they would have received if the debtor initially had filed under Chapter 7." *Ibid.* Moreover, returning undistributed funds to debtors "furthers Congress's preference that on conversion to Chapter 7 a Chapter 13 debtor receive all post-petition property that is held by the Chapter 13 trustee, but still is under the control of the debtor, so that debtors are encouraged to attempt to repay their debts through reorganization rather than liquidation." *Id.* at 316. A contrary rule, the Third Circuit emphasized, "would dissuade debtors from filing under Chapter 13" in the first place. *Id.* at 315.

In the Fifth Circuit's view, however, "[b]oth the district court in this case and the Third Circuit in *Michael*" placed too much weight on "a congressional policy of encouraging debtors to attempt repayment through Chapter 13 and removing disincentives that would discourage this." App., *infra*, 22a. A debtor would not be "meaningfully deterred" from pursuing reorganization under Chapter 13, the court posited, "by the knowledge that payments made under a confirmed Chapter 13 plan will not be returned to

him if he chooses to convert to Chapter 7." *Id.* at 24a. In that respect, the court agreed with Judge Roth's dissenting opinion in *Michael* that post-petition wages are different from other property the debtor acquires after filing a bankruptcy petition. *Id.* at 23a–26a. The Fifth Circuit likewise sided with Judge Roth in concluding that "strong considerations of fairness" supported post-conversion payments to creditors. *Id.* at 26a. In particular, it held that "'the attached wages are the *quid pro quo* that the debtor has given up during the pendency of the reorganization in return for being permitted to stave off foreclosure and cure the mortgage default * * * and enjoy the automatic stay.'" *Id.* at 26a–27a (quoting *In re Michael*, 699 F.3d at 319 (Roth, J., dissenting)).

In sum, the Third Circuit's decision in *Michael* is squarely at odds with the Fifth Circuit's decision below. The two Circuits addressed essentially identical facts, and their resulting decisions demonstrate a sharp disagreement over what both the Bankruptcy Code and Congressional bankruptcy policy require. Each Circuit fully developed its view of the law in a careful opinion, and future decisions by other courts of appeals will likely just fall in behind one or the other side in this debate. There is no reason to believe this split among the circuits will resolve itself, and every reason to believe it will continue to deepen.

B. As the court of appeals recognized below, its acknowledged disagreement with the Third Circuit reflects a contested legal issue that "has divided courts for thirty years." App., *infra*, 2a. And so it has. On at least ten occasions, a bankruptcy court, district court, or bankruptcy appellate panel has held

(like the Third Circuit in *Michael*) that undistributed funds held by a Chapter 13 trustee should be refunded to the debtor upon conversion.[3] By contrast, on at least fifteen occasions, a bankruptcy court has held (like the court of appeals below) that such funds should be distributed to creditors.[4] These 25

---

[3] *In re Murphy*, Nos. 09-81861, 12-30813, 2014 WL 2600168, at *2–*3 (Bankr. M.D. Ala. Feb. 11, 2014); *Gallagher* v. *Dockery (In re Gallagher)*, No. CC-13-1368-TaKuPa, 2014 WL 998411, at *6 (B.A.P. 9th Cir. Mar. 17, 2014); *In re Krahenbuhl*, No. 09-29618-svk, 2013 WL 3793405, at *2 (Bank. E.D. Wisc. July 19, 2013); *In re Harris*, App., *infra*, 29a–49a; *In re Harris*, App., *infra*, 50a–51a; *In re Horne*, No. 97-20171, 2002 WL 33939743, at *4 (Bankr. D. Idaho Jan. 10, 2002); *DeHart* v. *Michael (In re Michael) ("Michael II")*, 446 B.R. 665, 667 (M.D. Pa. 2011); *In re Michael ("Michael I")*, 436 B.R. 323, 331 (Bankr. M.D. Pa. 2010); *In re Boggs*, 137 B.R. 408, 410–11 (Bankr. W.D. Wash. 1992); *In re Bullock*, 41 B.R. 637, 638–41 (Bankr. E.D. Pa 1984).

[4] *In re Smith*, 511 B.R. 612, 620–21 (Bankr. W.D. Mo. 2014); *In re Markham*, 504 B.R. 1, 8 (Bankr. D. Mass. 2013); *Spero* v. *Porreco (In re Porreco)*, 426 B.R. 529, 537 (Bankr. W.D. Pa. 2010) (overruled by *In re Michael*); *Chase* v. *Winnecour (In re Chase)*, No. 03-10092, 2008 WL 2309529, at *1 (Bankr. W.D. Pa. June 4, 2008) (overruled by *In re Michael*); *In re Pegues*, 266 B.R. 328, 334 (Bankr. D. Md. 2001); *In re Salisbury*, No. 99-10431C-7G, 2000 WL 33673758, at *2 (Bankr. M.D.N.C. Nov. 17, 2000); *In re Bell*, 248 B.R. 236, 239–40 (Bankr. W.D.N.Y. 2000); *In re Hardin*, 200 B.R. 312, 314 (Bankr. E.D. Ky. 1996); *O'Quinn* v. *Brewer (In re O'Quinn)*, 143 B.R. 408, 413 (Bankr. S.D. Miss. 1992); *In re Galloway*, 134 B.R. 602, 602–04 (Bankr. W.D. Ky. 1991); *In re Halpenny*, 125 B.R. 814, 815–16 (Bankr. D. Haw. 1991); *In re Milledge*, 94 B.R. 218, 219–20 (Bankr. M.D. Ga. 1988); *Ledford* v. *Burns (In re Burns)*, 90 B.R. 301, 305 (Bankr. S.D. Ohio 1988); *Waugh* v. *Saldamarco (In re Waugh)*, 82 B.R. 394, 400 (Bankr. W.D. Pa. 1988) (overruled by

decisions, moreover, are just those in which a bankruptcy or district judge entered a written opinion on the question presented in this case; it stands to reason that the same issue has been determined on the record or by unadorned order countless times more.

This three-decade-old division is also deepening with time. In just the two years since *Michael*, the Ninth Circuit's bankruptcy appellate panel and bankruptcy courts in Alabama and Wisconsin have adopted the Third Circuit's approach (see *supra* note 3 (citing cases)), but bankruptcy courts in Missouri and Massachusetts have adopted the approach taken by the Fifth Circuit below (see *supra* note 4 (citing cases)).

Each of these conflicting decisions resolved the fate of funds meaningfully important to an individual debtor seeking a "fresh start" out of bankruptcy. Yet these sums of money—in the thousands or tens or thousands of dollars—are often not enough to justify a debtor's expenditure of limited resources to pursue one or multiple appeals. Perhaps for that reason, there have not been a large number of decisions on this issue by the Circuits. This case therefore provides this Court a somewhat rare opportunity to address and resolve a recurring question of bankruptcy law that is of tremendous practical importance and has caused problems for the bankruptcy and district courts for three decades.

In re Michael); *In re Redick*, 81 B.R. 881, 887 (Bankr. E.D. Mich. 1987).

II. The Decision Below Is Erroneous

As the Third Circuit correctly held in *Michael*, the Bankruptcy Code points—more than once—toward a requirement that Chapter 13 trustees return undistributed payments to a debtor upon conversion to Chapter 7. Such a rule is also consistent with the policy choices Congress expressed in those Code provisions by providing incentives for debtors to attempt Chapter 13 reorganizations.

A. Numerous provisions of the Bankruptcy Code show that Congress intended for Chapter 13 trustees to return undistributed funds to the debtor upon conversion to Chapter 7.

1. Returning undistributed funds to the debtor upon conversion follows from the text of Section 348, which governs the effect of conversion from Chapter 13 to Chapter 7. Two subsections of Section 348 provide debtors the ability to make a clean break with their Chapter 13 proceeding without any penalty.

Section 348(f) states that, "[e]xcept" when a debtor has acted bad faith, the post-conversion Chapter 7 estate comprises only the debtor's *petition-date* property, and none of the *post-petition* property (including wages) that was in the Chapter 13 estate. Until 1994, the Circuits were split over whether funds held by the Chapter 13 trustee at conversion became part of the Chapter 7 estate (with those courts answering "no" in turn split over whether the debtor or his creditors get them). App., *infra*, 5a–6a. "In 1994, Congress resolved the circuit split by enacting 11 U.S.C. § 348(f)." *Id.* at 6a. In adopting Section 348(f), therefore, Congress considered *but*

rejected making a debtor's undistributed, post-petition wages and other property available to his creditors after conversion through the resulting Chapter 7 estate. As a House Report accompanying the amendment stated, Congress's intent was to avoid the "serious disincentive" to attempting a Chapter 13 reorganization if a Chapter 7 estate included debtor's post-petition property *only in a converted case*. See *id.* at 7a–9a (quoting H.R. Rep. No. 103-835, at 57 (1994)).

In short, the Chapter 13 estate that includes debtors' post-petition wages terminates upon conversion, and the resulting Chapter 7 estate does not include those wages. It would be passing strange to think that Congress intended to permit an end-run around the legislative choice embodied in Section 348(f) by which funds that were *not* to be included in the Chapter 7 estate would nonetheless find their way to creditors. There is simply no statutory authority for the distribution to creditors of funds that are no longer the property of *any* estate.

What is more, to prevent debtors from taking advantage of this feature of the bankruptcy process, Congress provided that the Chapter 7 estate *would* retain a debtor's post-petition property if the debtor had converted his case *in bad faith*. 11 U.S.C. § 348(f)(2). That limited "except[ion]" built into the text of Section 348(f) necessarily indicates that debtors who convert their cases *in good faith* will *retain* all of their post-petition property (including undistributed post-petition wages). See *In re Michael*, 699 F.3d at 314.

The Fifth Circuit below sought to side-step that inference by noting that "undistributed post-petition

wages" are "only a subset of the debtor's post-petition property" to which the bad-faith exception applies. App., *infra*, 21a. Accordingly, the court believed, its holding would not render Congress's penalty for bad-faith conversion "superfluous." *Id.* at 21a–22a. Superfluity is not the issue, however. The point is that a debtor's post-petition wages are *among* the property that Congress intended debtors to keep upon a good-faith conversion to Chapter 7, but to lose to the Chapter 7 estate upon a bad-faith conversion. It is no answer to say, as the court of appeals did, that *most* of Congress's intent is unaffected by carving out only *part* of what it intended.

2. Moreover, Section 348(e) provides that conversion "terminates the service" of the Chapter 13 trustee. 11 U.S.C. § 348(e). That provision, as the Third Circuit concluded, incapacitates the trustee from continuing to distribute the property of the former Chapter 13 estate to creditors. See *In re Michael*, 699 F.3d at 310 (holding that Section 348(e) "seemingly renders [the trustee] powerless to make payments to creditors under a Chapter 13 plan" after conversion).

The Fifth Circuit thought that the Third Circuit had taken the language of Section 348(e) "'too literally.'" App., *infra*, 10a (quoting *In re Parrish*, 275 B.R. at 430). "'[T]here is no logical reason,'" the court believed, "'why distribution of funds pursuant to the previously confirmed reorganization plan cannot be included" among the Chapter 13 Trustee's post-conversion "administrative duties." App., *infra*, 11a (quoting *In re Michael*, 699 F.3d at 320 n.8 (Roth, J., dissenting)). Yet the ancillary "administrative duties" a Chapter 13 trustee has after conversion—

principally to account for the former Chapter 13 estate in a final report—is not the "service" that Section 348(e) is intended to "terminate[]." It is the trustee's role as the debtor's disbursing agent—collecting funds from the debtor and distributing those funds to creditors—that is meant to cease upon conversion. Restoring to a debtor any garnished wages that were not distributed while the trustee was still performing that "service" is a mere administrative duty in a way that continuing to parcel out those funds to creditors is not.

3. Section 1327(b) states that confirmation of a Chapter 13 plan "vests all of the property of the estate in the debtor" "[e]xcept as otherwise provided in the plan or the order confirming the plan." 11 U.S.C. § 1327(b). That "property of the estate" undoubtedly includes debtor's post-petition wages. 11 U.S.C. § 1306(a)(2). Whether such funds are held by the Chapter 13 trustee or by the debtor, they are property of the estate, vested in the debtor, unless and until those funds are distributed to creditors. Indeed, the court of appeals recognized that creditors lack any vested interest in such funds until they receive them. App., *infra*, 14a–18a (rejecting respondent's contrary argument).

When a Chapter 13 case is converted after plan confirmation, however, the Chapter 13 estate ceases to exist. The former "property of the estate" that was vested in the debtor upon plan confirmation (§ 1327(b)) *remains* vested in the debtor, and it must be returned to the debtor under settled principles of property law.

In holding otherwise, the court of appeals focused on Section 1327(b)'s caveat for contrary

vesting rights established by the confirmed plan or confirmation order. App., *infra*, 19a–20a. The court concluded that petitioner's Chapter 13 plan, by providing for monthly payments to respondent, had extinguished petitioner's vested interest in those funds. "[T]he debtor certainly does not retain possession of these payments," the court stated, and so "it would seem that the confirmation order specifically divests the debtor of any interest he may have in the payments made to the trustee." *Id.* at 20a. Not so. Prior to conversion, funds held by the debtor or by the trustee were in either case "property of the estate"; the presumption in Chapter 13 is that the debtor will *possess* the property of the estate, but the plan may direct otherwise. See 11 U.S.C. § 1306(b). As the Third Circuit held in *Michael*, the fact that some property of the estate is held by the trustee has no bearing on debtor's vested interest in all of that property. 699 F.3d at 313; see also *In re Plata*, 958 F.2d at 922 (reaching the same conclusion under Chapter 12's corresponding provision for bankrupt family farmers and family fishermen, 11 U.S.C. § 1227(b)).

Such a reading of Section 1327(b) is consistent with other provisions of the Bankruptcy Code that require the trustee to return funds to the debtor under other circumstances. See *United Sav. Ass'n of Tex.* v. *Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) ("Statutory construction * * * is a holistic endeavor."). If a Chapter 13 plan is not confirmed, Section 1326(a)(2) requires that any funds the debtor has already paid to the trustee be restored to the debtor. Likewise, if a Chapter 13 case is dismissed, Section 349(b)(3) requires funds held by the trustee to be returned to the debtor. Creating a

different rule for conversions is nonsensical. If petitioner had moved to dismiss his Chapter 13 case instead of converting it, there is no dispute that respondent would have refunded any undistributed funds to him under Section 349(b)(3). There is "no justification for requiring a debtor to dismiss, rather than convert * * * in order to preserve" certain benefits, and any contrary requirement "creat[es] a trap for the unwary," "elevate[s] form over substance," and "inject[s] a needless degree of extra work on the part of all concerned." *In re Plata*, 958 F.2d at 922; see also *In re Michael*, 699 F.3d at 313–14 n.6.

B. After erroneously concluding that there is "little guidance in the Bankruptcy Code" bearing on this question, the court of appeals "turn[ed] to considerations of equity and policy" to fill the perceived gap. App., *infra*, 22a. In doing so, the court understated the disincentives its rule creates for debtors who are contemplating reorganization under Chapter 13, and overstated the "strong considerations of fairness" it perceived as demanding post-conversion distributions to creditors. *Id.* at 26a.

1. The decision below produces a significant disincentive against a debtor *continuing* to proceed in Chapter 13 after a change in circumstances. In this case, for example, petitioner's mortgagor received relief from the stay, and the trustee began to withhold the portion of petitioner's garnished wages that his Chapter 13 plan directed to that mortgagor. App., *infra*, 4a–5a. For a year thereafter, however, petitioner continued to make a go of his Chapter 13 plan. As a result, $158 of his monthly wages kept flowing to his other creditors.

This was an unmitigated benefit to those creditors. If petitioner had converted to Chapter 7 immediately when his mortgagor received relief from the stay, those payments never would have been made. Petitioner's modest assets (after losing his home) were exempt from a Chapter 7 liquidation, see *supra* note 1, so his creditors stood to receive nothing from the estate once he converted his case. He kept paying them anyway. But if petitioner had known that, by delaying conversion and continuing in Chapter 13, his other creditors would also end up obtaining the withheld funds his plan intended for his mortgagor, petitioner's most rational choice would have been to abandon Chapter 13 (and his creditors) at the first available opportunity.

The court of appeals' decision also provides a disincentive to attempting a repayment plan under Chapter 13 in the first place. From the debtor's perspective, one of the most significant differences between Chapter 13 and Chapter 7 is that in Chapter 13—but not Chapter 7—wages and property the debtor acquires *after* the petition date become "property of the estate." Compare 11 U.S.C. § 1306 (Chapter 13) with *id.* § 541 (Chapter 7). That provides a benefit to a debtor, who can repay his creditors out of his future income and stave off the liquidation of his house, car, and other assets to pay those debts. The debtor must feel confident, however, that if those goals are not met—*e.g.*, the car or the home is lost to creditors—that he can turn off the spigot of payments out of his post-petition income by converting his case to Chapter 7. Any risk that creditors will get "bonus" payments out of his post-petition wages *despite* such a conversion increases

the risks associated with proceeding in Chapter 13 in the first place.

Indeed, if the result below were to hold, petitioner's case will be a cautionary tale for any individual debtor contemplating Chapter 13. If petitioner had proceeded under Chapter 7 from the start, his home would have been liquidated to pay his mortgagor. Petitioner, after having surrendered his car, had no other assets that were not exempt from the Chapter 7 estate under Section § 522(b) of the Bankruptcy Code. See *supra* note 1. Accordingly, petitioner would have received a discharge of his other debts in Chapter 7 without any other asset sales or payments. His post-petition wages would have been his and his alone.

2. The court of appeals was also wrong to conclude that the "distribution of the funds to creditors is supported by strong considerations of fairness." App., *infra*, 26a.

The court relied on Judge Roth's dissent from the Third Circuit's decision in *Michael*, along with a handful of bankruptcy court decisions containing similar reasoning, to hold that it would be unfair to creditors if the Chapter 13 trustee returned payments to the debtor upon conversion to Chapter 7. See App., *infra*, 26a–28a. Those funds, the argument goes, were the debtor's "'*quid pro quo*'" for the benefits he had received during the Chapter 13 case—*i.e.*, "stav[ing] off foreclosure and cur[ing] the mortgage default." *Id.* at 26a (quoting *In re Michael*, 699 F.3d at 319 (Roth, J., dissenting)). That "'arrangement,'" the court stated, is not "retroactively alter[ed]" by conversion. *Id.* at 27a (quoting *In re Michael*, 699 F.3d at 320 n.8 (Roth, J.,

dissenting)). Nor does conversion, according to the Fifth Circuit, "undo the disadvantages that creditors may have suffered as a result of the [Chapter 13] plan." *Id.* at 27a.

That is exactly backwards. Many debtors, including petitioner, convert their cases from Chapter 13 to Chapter 7 because the former's "benefits" have proven illusory. When petitioner converted his case—just as when the debtor in *Michael* converted his—petitioner had already lost his home. App., *infra*, 4a; see also 699 F.3d at 307. In both cases, the funds the Chapter 13 trustee held at conversion had been garnished from the debtors' wages *after* each debtor had failed to "'stave off foreclosure and cure the mortgage default.'" App., *infra*, 26a (quoting *In re Michael*, 699 F.3d at 319 (Roth, J., dissenting)). The creditors to which the Chapter 13 trustee ultimately distributed those funds after conversion had not expected to receive such payments from the estate so early in the Chapter 13 plan's term. As to those creditors, the funds held by the trustee had not been the *quid pro quo* for anything.

Moreover, when petitioner filed for bankruptcy protection, his only non-exempt asset was his home.[5] If petitioner had filed his case under Chapter 7 from the start, then his home would have been sold, his mortgagor would have received the proceeds, and the rest of his debts would have been discharged to the

---

[5] Petitioner also had possession of an automobile, but he surrendered that car, on or around the petition date, to the secured lender on his car loan. App., *infra*, 27a n.12.

extent authorized by law. It was petitioner's election to proceed under Chapter 13 in an attempt to save his home that provided his other creditors any opportunity to recover anything at all. Under the circumstances, it is hard to see why those creditors are entitled to receive additional post-conversion payments out of petitioner's post-petition wages as a matter of equity. Quite the contrary; fairness demands that petitioner "not lose those earnings on conversion." *In re Michael*, 699 F.3d at 315.

III. The Issue Is Recurring And Important To The Administration Of Chapter 13

The question presented is an important issue of bankruptcy law that affects many individual debtors each year who typically cannot afford to litigate this long-disputed legal issue.

During the twelve-month period ending June 30, 2014, debtors filed 321,278 Chapter 13 cases.[6] Approximately two-thirds of Chapter 13 cases end in dismissal or conversion rather than a discharge of debts. Katherine Porter, *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, 90 Tex. L. Rev. 103, 108 (2011). For those Chapter 13 cases that do not end in a discharge, about 26% of them are

---

[6] Admin. Office of the U.S. Courts, Table F-2, *U.S. Bankruptcy Courts—Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending June 30, 2014*, at http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2014/0614_f2.pdf ("6/30/14 Bankruptcy Statistics").

converted to Chapter 7. *Id.* at 112. Thus, roughly 60,000 Chapter 13 bankruptcy cases are converted to Chapter 7 each year. That suggests that, in the Third and Fifth Circuits alone, there are roughly 10,000 of these conversions annually. See 6/30/14 Bankruptcy Statistics at 1–2 (reporting 17,216 Chapter 13 petitions in the Third Circuit and 39,020 in the Fifth Circuit).

When many of these conversions occur, the trustee holds payments that had been made by the debtor under the Chapter 13 plan. Although Section 1326(a)(2) instructs trustees to distribute funds in their possession to creditors "as soon as is practicable," trustees cannot do so instantaneously. Generally, distributions are made monthly or biweekly. See *In re Michael*, 699 F.3d at 316. There is every reason to believe, moreover, that there are a significant number of cases like this one, and *Michael*, in which relief from the stay by a secured home or auto lender has caused the Chapter 13 trustee to retain more than just the prior wage garnishment.

Until this Court settles the issue, debtors and trustees alike are forced to navigate the uncertainty. The Department of Justice's *Handbook for Chapter 13 Standing Trustees* candidly advises Chapter 13 trustees that

> [i]f [a Chapter 13] case is * * * converted post-confirmation, the standing trustee must distribute any funds on hand in accordance with controlling law of the jurisdiction. Courts are divided on the issue of the disposition of funds if the case is converted to chapter 7. The standing trustee must follow legal authority in the

> jurisdiction, or seek a court order regarding disposition of the funds.

U.S. Dep't of Justice, Exec. Office for U.S. Trustees, *Handbook for Chapter 13 Standing Trustees* 3-36 (Oct. 1, 2012) (internal citation omitted).

Three decades of litigation to determine the "legal authority" in each "jurisdiction" has already sapped scarce resources. Debtors, in particular, are burdened enough as it is without being saddled with the legal expense of figuring out whether a particular bankruptcy judge will adhere to the Third Circuit's view or the Fifth Circuit's. Debtors converting from a Chapter 13 repayment plan to a Chapter 7 liquidation often do so because they are eager to hasten their fresh start out of bankruptcy. The average Chapter 13 proceeding lasts three to five years; the average Chapter 7 proceeding takes roughly four months. Porter, *supra*, at 108, 116–17. In this context, certainty is important. To make rational decisions as intended by the Bankruptcy Code, a debtor contemplating conversion needs to know what funds will be restored to him and what funds will not.

Today, however, the disposition of what often amounts to a petitioner's sole remaining assets turns on the Circuit—or even just the bankruptcy court—in which a debtor finds himself. This Court should grant the petition to provide certainty to debtors and ensure "uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const., art. 1, § 8, cl. 4.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

J. TODD MALAISE
STEVEN G. CENNAMO
MALAISE LAW FIRM
909 N.E. LOOP 410, STE. 300
SAN ANTONIO, TEXAS
(210) 732-6699

MARK T. STANCIL
Counsel of Record
ALAN E. UNTEREINER
MATTHEW M. MADDEN
ROBBINS, RUSSELL, ENGLERT,
ORSECK, UNTEREINER &
SAUBER LLP
1801 K STREET, N.W., STE. 411L
WASHINGTON, D.C. 20006
(202) 775-4500
mstancil@robbinsrussell.com

October 2014

APPENDIX

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 13-50374

In the Matter of: CHARLES E. HARRIS, III,

Debtor

MARY K. VIEGELAHN, Chapter 13 Trustee,

Appellant

v.

CHARLES E. HARRIS, III,

Appellee

Appeal from the United States District Court
for the Western District of Texas

Before BENAVIDES, CLEMENT, and GRAVES, Circuit Judges.

JAMES E. GRAVES, JR., Circuit Judge:

Charles Harris filed a bankruptcy petition under Chapter 13, made regular payments from his

wages to the trustee under a confirmed Chapter 13 plan, and eventually converted his case to Chapter 7. The district court held that payment funds in the possession of the Chapter 13 trustee that had not been distributed to creditors at the time of conversion must be returned to Harris. This appeal filed by the trustee presents a single question of law: should the undistributed payments held by the Chapter 13 trustee at the time of conversion be returned to the debtor or distributed to creditors pursuant to the Chapter 13 plan? This question has divided courts for thirty years,[1] although only one appellate court

---

[1] Opinions holding that the funds should be distributed to creditors include *In re Pegues*, 266 B.R. 328 (Bankr. D. Md. 2001); *In re Bell*, 248 B.R. 236 (Bankr. W.D.N.Y. 2000); *In re Hardin*, 200 B.R. 312 (Bankr. E.D. Ky. 1996); *In re O'Quinn*, 143 B.R. 408 (Bankr. S.D. Miss. 1992); *In re Galloway*, 134 B.R. 602 (Bankr. W.D. Ky. 1991); *In re Halpenny*, 125 B.R. 814 (Bankr. D. Haw. 1991); *In re Milledge*, 94 B.R. 218 (Bankr. M.D. Ga. 1988); *Matter of Burns*, 90 B.R. 301 (Bankr. S.D. Ohio 1988); *In re Waugh*, 82 B.R. 394 (Bankr. W.D. Pa. 1988); *In re Redick*, 81 B.R. 881 (Bankr. E.D. Mich. 1987); *In re Rutenbeck*, 78 B.R. 912 (Bankr. E.D. Wis. 1987); and *In re Lennon*, 65 B.R. 130 (Bankr. N.D. Ga. 1986) (dicta).

Opinions holding that the funds should be returned to the debtor include *In re Michael*, 436 B.R. 323 (Bankr. M.D. Pa. 2010) ("*Michael I*"); *In re Boggs*, 137 B.R. 408 (Bankr. W.D. Wash. 1992); *In re de Vos*, 76 B.R. 157 (N.D. Cal. 1987); *In re Luna*, 73 B.R. 999 (N.D. Ill. 1987); *In re Peters*, 44 B.R. 68 (Bankr. M.D. Tenn. 1984); *In re Bullock*, 41 B.R. 637 (Bankr. E.D. Pa. 1984); *In re McFadden*, 37 B.R. 520 (Bankr. M.D. Pa. 1984); and *In re Hannan*, 24 B.R. 691 (Bankr. E.D.N.Y. 1982). However, many of the earlier opinions in the latter category, after determining that the funds do not become part of the new Chapter 7 estate, did not go on to consider whether creditors may nonetheless be entitled to them under the old Chapter 13 plan.

has squarely answered it.[2] For the reasons explained below, we hold that the payments must be distributed to creditors. Accordingly, we REVERSE the district court's order and REMAND the case to the district court.

BACKGROUND

In February 2010, Charles E. Harris, III, filed a petition for relief under Chapter 13 of the Bankruptcy Code. At the time of filing, he was $3,700 behind on his home mortgage loan, which was held by Chase. His proposed Chapter 13 plan was confirmed in April 2010. The plan called for Harris to make monthly payments of $530 to the trustee, Mary K. Viegelahn, out of his gross monthly income of $4,082.87, for 60 months. From each payment, $352 was to go to Chase to pay off the arrears on his

---

[2] *In re Michael*, 699 F.3d 305 (3rd Cir. 2012) ("*Michael II*") (holding that the undistributed funds must be returned to the debtor). Other circuits have addressed similar questions. *See, e.g.*, *In re Stamm*, 222 F.3d 216 (5th Cir. 2000) (holding that when a Chapter 13 case is converted to Chapter 7 *before confirmation of a plan*, wages paid by the debtor to the trustee under the proposed plan do not become part of the Chapter 7 estate and must be returned to the debtor); *In re Young*, 66 F.3d 376 (1st Cir. 1995) (holding that earnings paid to a Chapter 13 trustee pursuant to a confirmed plan do not become part of the Chapter 7 estate upon conversion, without analyzing what should be done with these funds); *In re Nash*, 765 F.2d 1410 (9th Cir. 1985) (holding that any undistributed earnings paid to a Chapter 13 trustee pursuant to a confirmed plan must be returned to the debtor upon *dismissal* of the Chapter 13 case).

mortgage and approximately $75 was to go to Conns, the only other secured creditor, to repay a $900 debt on a television. After these debts and the debts to Harris' lawyer were paid off, the payments would go to Harris' unsecured creditors, who had claims against him for $20,458. The plan also called for Harris to make monthly mortgage payments of $960 directly to Chase.

In October 2010, Chase moved to lift the automatic stay with respect to Harris' home, stating that Harris had failed to make mortgage payments as required by the plan. The stay was lifted in November 2010. Harris then moved out of his house, and it was presumably foreclosed upon. Harris kept making monthly payments of $530 to Viegelahn for approximately a year before converting to Chapter 7 and did not attempt to modify the plan. However, after the automatic stay was lifted, Viegelahn placed a hold on the portion of the monthly payments intended to go to Chase. As a result, the funds in Viegelahn's possession began to accumulate.

Harris voluntarily converted his bankruptcy case to Chapter 7 on November 22, 2011. At that time, $5,519.22 remained in Viegelahn's possession. Attached to Harris' notice of conversion was an assignment of funds assigning $1,200 of the remaining funds to Harris' counsel in payment for legal fees. Viegelahn paid $1,200 to Harris' counsel on November 22, 2011. On December 1, 2011, Viegelahn distributed the remaining $4,319.22 as follows: $397.68 to Conns; $3,583.78 to six unsecured creditors; and $267.79 to herself as commission. Finally, on December 5, 2011, Viegelahn filed the

final report and account for the Chapter 13 case.

Harris moved to compel the return of the $4,319.22 that Viegelahn had distributed to his creditors, arguing that she had no authority to disburse funds after conversion of the case. After a hearing, the bankruptcy court issued an order compelling the return of the funds. Viegelahn appealed to the district court, and the district court affirmed the bankruptcy court's order. Viegelahn now appeals to this court.

DISCUSSION

I. Conversion From Chapter 13 to Chapter 7

The filing of a Chapter 7 petition creates an estate that comprises, with certain exceptions, all of the debtor's property at the time of filing. 11 U.S.C. § 541. Property acquired after the date of filing is generally not included in the estate. *See* 11 U.S.C. § 541(a). The estate is then liquidated to pay creditors and any remaining debt is, with certain exceptions, discharged. On the other hand, a Chapter 13 filing proposes a plan to pay creditors with future income rather than liquidation of existing assets. *See* 11 U.S.C. § 1322. Accordingly, the Chapter 13 estate includes, in addition to property held at the time of filing, any property or earnings acquired after filing but before the case is closed, dismissed, or converted. 11 U.S.C. § 1306(a).

A debtor who is unwilling or unable to continue paying creditors under a Chapter 13 plan may convert his case to a Chapter 7 liquidation at any time. 11 U.S.C. § 1307(a). Because of the differences

between a Chapter 13 estate and a Chapter 7 estate, such a conversion raises an inevitable question: does the Chapter 7 estate include all property held by the debtor at the time of conversion, or does it include only the property held at the time of the original Chapter 13 filing? Before 1994, there was a circuit split on this question.

In *In re Bobroff*, 766 F.2d 797, 803 (3rd Cir. 1985), the Third Circuit held that a tort action that had accrued while a debtor was proceeding under Chapter 13 would not become part of the estate upon conversion to Chapter 7. The court noted "the Bankruptcy Code's goal of encouraging the use of debt repayment plans rather than liquidation," and explained that "[i]f debtors must take the risk that property acquired during the course of an attempt at repayment will have to be liquidated for the benefit of creditors if chapter 13 proves unavailing, the incentive to give chapter 13—which must be voluntary—a try will be greatly diminished." *Id.* On the other hand, in *Matter of Lybrook*, 951 F.2d 136, 137-38 (7th Cir. 1991), the Seventh Circuit held that farm land worth $70,000 that the debtor had inherited while proceeding under Chapter 13 would be included in the Chapter 7 estate upon conversion. The court held that "the Chapter 13 estate passes unaltered into Chapter 7 upon conversion," explaining that "a rule of once in, always in is necessary to discourage strategic, opportunistic behavior that hurts creditors without advancing any legitimate interest of debtors." *Id.*

In 1994, Congress resolved the circuit split by enacting 11 U.S.C. § 348(f), which provides that

> when a case under chapter 13 . . . is converted to a case under another chapter . . . property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.

Id. at § 348(f)(1). On the other hand, "[i]f the debtor converts a case under chapter 13 . . . to a case under another chapter . . . in bad faith, the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion." *Id.* at § 348(f)(2). The House Report accompanying the act explains the purpose of the amendment:

> This amendment would clarify the Code to resolve a split in the case law about what property is in the bankruptcy estate when a debtor converts from chapter 13 to chapter 7. The problem arises because in chapter 13 (and chapter 12), any property acquired after the petition becomes property of the estate, at least until confirmation of a plan. Some courts have held that if the case is converted, all of this after-acquired property becomes part of the estate in the converted chapter 7 case, even though the statutory provisions making it property of the estate do not apply to chapter 7. Other courts have held that property of the estate in a converted

case is the property the debtor had when the original chapter 13 petition was filed.

These latter courts have noted that to hold otherwise would create a serious disincentive to chapter 13 filings. For example, a debtor who had $10,000 equity in a home at the beginning of the case, in a State with a $10,000 homestead exemption, would have to be counseled concerning the risk that after he or she paid off a $10,000 second mortgage in the chapter 13 case, creating $10,000 in equity, there would be a risk that the home could be lost if the case were converted to chapter 7 (which can occur involuntarily). If all of the debtor's property at the time of conversion is property of the chapter 7 estate, the trustee would sell the home, to realize the $10,000 in equity for the unsecured creditors and the debtor would lose the home.

This amendment overrules the holding in cases such as *Matter of Lybrook*, 951 F.2d 136 (7th Cir. 1991) and adopts the reasoning of *In re Bobroff*, 766 F.2d 797 (3d Cir. 1985). However, it also gives the court discretion, in a case in which the debtor has abused the right to convert and converted in bad faith, to order that all property held at the time of conversion

> shall constitute property of the estate in the converted case.

H.R. Rep. No. 103-835, at 57 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3366.

After the passage of § 348(f), it is clear that property acquired after the filing of a Chapter 13 petition, including wages, does not become part of the Chapter 7 estate upon conversion (absent bad faith). Specifically, this means that any funds paid by the debtor to the trustee pursuant to the Chapter 13 plan that have not been distributed at the time of conversion are not transferred to the Chapter 7 estate. However, no statute explicitly states what should happen to these funds. Harris argues that the funds should be returned to him, whereas Viegelahn argues that the funds should be distributed to creditors pursuant to the Chapter 13 plan.

II. Statutory Arguments

Harris relies upon our opinion in *Stamm* for the proposition that all post-petition wages belong to the debtor upon conversion from Chapter 13 to Chapter 7. However, the holding of *Stamm* is more limited – we held that when a Chapter 13 case is converted *before a plan is confirmed*, wages paid to the Chapter 13 trustee "are not part of the Chapter 7 estate, and must be returned to the Debtors." *Stamm*, 222 F.3d at 217. This is consistent with the Bankruptcy Code, which explicitly states that if a plan is not confirmed, any payments made under a proposed Chapter 13 plan must be returned to the debtor (after certain deductions are made). 11 U.S.C. § 1362(a)(2). However, there is no analogous

provision requiring that undistributed payments made pursuant to a confirmed Chapter 13 plan be returned to the debtor. Accordingly, *Stamm* is not controlling here.

Relying on 11 U.S.C. § 348(e), Harris argues that "the Trustee has no authority to disburse funds after her services are terminated." Section 348(e) provides that "[c]onversion of a case . . . terminates the service of any trustee or examiner that is serving in the case before such conversion." However, Harris' argument is obviously not intended to be taken at face value; if the trustee has "no authority to disburse funds," she would be unable to return the funds to Harris as he requests. To the extent that she is still holding funds belonging to someone else, she is plainly a trustee in some real sense, even if her services have been "terminated." *See Redick*, 81 B.R. at 886 ("Even if the Chapter 13 trustee no longer has that title, and no longer has the absolute duty to distribute the funds to the creditors pursuant to the confirmed Chapter 13 plan because the order confirming the plan and the plan have disintegrated, the Chapter 13 trustee is, at the very least, a custodian of funds having the duty to deliver them to the party with the best claim to them."). Moreover, after conversion, a Chapter 13 trustee still has the duty to turn over to the Chapter 7 trustee any records and property of the estate in her possession or control, and to file a final report and account. Fed. R. Bankr. P. 1019(4) and (5)(B)(ii). Accordingly, "[t]he language of § 348(e) terminating the trustee's services upon conversion cannot be taken too literally." *In re Parrish*, 275 B.R. 424, 430 (Bankr. D.D.C. 2002).

At least one court has distinguished "post-confirmation reporting duties" from "substantive administrative matters related to a chapter 13 trustee's core responsibilities," holding that the trustee retains the authority to carry out the former duties but not the latter. *See Michael I*, 436 B.R. at 330-31. However, "[s]ince Congress intended for the trustee to perform several ancillary duties to clean-up and finalize the administration of the estate, . . . there is no logical reason why distribution of funds pursuant to the previously confirmed reorganization plan cannot be included as one of those administrative duties." *Michael II*, 699 F.3d at 320 n.8 (Roth, J., dissenting). Although it is clear, and understandable, that the Chapter 13 trustee does not retain any control over assets that have passed into the new Chapter 7 estate and come under the control of the Chapter 7 trustee, *see Perkins*, 36 B.R. at 620, this does not imply that the Chapter 13 trustee likewise loses control over assets outside the Chapter 7 estate. Even after termination of her services, Viegelahn still has a responsibility to distribute the remaining funds in her possession to the parties with the best claim to them. Section 348(e) does not establish who, between Harris and his creditors, has the better claim.

Harris also cites *In re Nash*, 765 F.2d 1410, 1413 (9th Cir. 1985), for the proposition that conversion of the case vacates the confirmed plan. However, *Nash* is inapposite here because it dealt with a dismissal rather than a conversion. In holding that undistributed funds held by the trustee must be returned to the debtor upon dismissal of a Chapter 13 case, *Nash* relied upon a statute that pertains only to

a dismissal,[3] and explicitly distinguished situations involving conversion:

> Even assuming that *Resendez* and *Giambitti* correctly hold that wage deductions received prior to dismissal no longer belong to a Chapter 13 debtor during the administration of the plan, those cases involved a conversion to Chapter 7. They do not address the fact that dismissal revests the property of the estate in the debtor. 11 U.S.C. § 349(b)(3). No similar Bankruptcy Rule or Code provision contemplates the revesting of the estate property upon conversion to Chapter 7.

Nash, 765 F.2d at 1414.[4]

Nevertheless, some courts have relied on *Nash* to hold that conversion of a Chapter 13 case "vacates" the Chapter 13 plan such that the trustee has no

---

[3] "Unless the court, for cause, orders otherwise, a dismissal of a case other than under [Chapter 7] . . . revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case . . . ." 11 U.S.C. § 349(b)(3).

[4] *See also In re Plata*, 958 F.2d 918, 922-23 (9th Cir. 1992) (Brunetti, J., dissenting) (explaining why the reasoning in *Nash* is inapplicable in conversion cases).

further authority to make payments to creditors pursuant to the plan. *See Michael I*, 436 B.R. at 329-30; *Boggs*, 137 B.R. at 410. Other courts before *Nash* have reached the same conclusion, for example:

> Upon confirmation of the debtors' Chapter 13 plan, title to the property of the Chapter 13 estate vests in the debtor except as otherwise provided in the plan or the order confirming the plan. 11 U.S.C. § 1327(b) [other citations omitted]. When a Chapter 13 case is converted to a case under Chapter 7, the Chapter 13 plan and the order confirming that plan are no longer in force. *In re Doyle*, 11 B.R. 110, 111 (Bankr. E.D. Pa. 1981). Since the Chapter 13 plan is no longer in effect, the creditors of the Chapter 13 debtor may not claim rights in the undistributed funds superior to the debtor. Thus, the undistributed funds held by the Chapter 13 trustee must be returned to the debtor.

Peters, 44 B.R. at 73.

We do not read so much into the fact that upon conversion, a Chapter 13 plan is "no longer in force." It is clear that after conversion, the debtor's continuing obligations under the plan (such as the obligation to keep making payments to the trustee) cease; likewise, the plan does not continue to bind creditors. However, it does not follow that the plan should thereafter be considered retroactively undone in full, and no statutory authority supports such an

interpretation. To the contrary: as discussed above, under the Bankruptcy Code conversion does not eliminate the trustee's power and duty to wrap up certain affairs of the estate. Similarly, there is no reason why prospective termination of the plan necessarily prohibits the trustee from distributing the funds remaining in her possession – which were paid at a time when the plan *was* still in force, and the debtor was still obligated to make payments – pursuant to the plan.

Viegelahn's statutory arguments are likewise unavailing. Relying primarily on 11 U.S.C. § 1326(a)(2), Viegelahn argues that creditors obtain a vested right to receive payments pursuant to a confirmed Chapter 13 plan once the debtor transfers the payments to the trustee. Under 11 U.S.C. § 1326(a)(1)(A), "[u]nless the court orders otherwise, the debtor shall commence making payments not later than 30 days after the date of the filing of the plan or the order for relief, whichever is earlier, in the amount . . . proposed by the plan to the trustee." Furthermore, under 11 U.S.C. § 1326(a)(2), "[i]f a [Chapter 13] plan is confirmed, the trustee shall distribute any such payment [made pursuant to paragraph (1)(A)] in accordance with the plan as soon as is practicable." Some courts have concluded that:

> The word "shall" in section 1326(a)(2) creates the condition of a trust. Creditors have a right to the funds in an active confirmed chapter 13 plan upon payment by the debtor. The speed by which the chapter 13 trustee makes distribution should not determine the

> rights of creditors and debtors in the funds. Payments received from debtors from post-petition property before the filing date of the motion to convert are subject to the confirmed chapter 13 plan.

Waugh, 82 B.R. at 400; *see also Galloway*, 134 B.R. at 603. Some courts have also noted the language in § 1326(a)(2) providing that "[i]f a plan is not confirmed, the trustee shall return any such payments" made pursuant to paragraph (1)(A), and have reasoned that the absence of a parallel provision dealing with undistributed post-confirmation funds suggests that such funds should *not* be returned to the debtor. *See, e.g.*, *Galloway*, 134 B.R. at 603; *Burns*, 90 B.R. at 304.

Most courts relying on § 1326(a)(2) to find vested rights in creditors have failed to recognize that the "shall distribute" language does not apply to post-confirmation payments made by the debtor to the trustee. One court did in fact recognize this limitation, but discerned a broader congressional purpose:

> While Section 1326(a)(2) does not specifically state that it applies to post-confirmation payments, we do have a congressionally stated intent that upon confirmation payments are to be disbursed pursuant to the plan. Logically, this was intended to include any payments made prior or subsequent to confirmation. When the provision is considered together with

> the Section 1326(c)[5] requirement that the trustee shall make payments to creditors and the previously noted exceptions of Section 1306 and 1327[6], one can reasonably infer that Congress intended that post-confirmation payments made pursuant to the plan are likewise to be distributed to creditors provided for by the plan.

Lennon, 65 B.R. at 137.

This reasoning, however, has been rejected by other courts:

> By its terms, § 1326(a)(2) does not pertain to funds received by a trustee *after* confirmation of a Chapter 13 plan. The cases finding "creditor vesting" of post-confirmation payments by implication from § 1326(a)(2) do so without citing legislative history for that proposition. . . .
>
> . . .
>
> I cannot conclude that Congress intended legislatively to create trusts

---

[5] 11 U.S.C. § 1326(c) states that "[e]xcept as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan."

[6] These provisions are discussed below.

> for creditors in enacting § 1326(a)(2) and (c); rather, Congress was apparently dealing with the question of when plan payments are to begin, the disposition of funds in the event no plan is confirmed, and who is to handle the funds.

Boggs, 137 B.R. at 410. Or, in slightly different terms: "§ 1326(a)(2) and (c) only address the obligation of the trustee to distribute payments in accordance with a confirmed plan; they do not vest creditors with any property rights." *Michael II*, 699 F.3d at 313.

Furthermore, if we were to hold that a debtor's payment of funds to the trustee pursuant to a Chapter 13 plan gives *specific* creditors a vested right to receive the funds, this would not support Viegelahn's actions. Under the plan in this case, $352 from each payment was intended to go to Chase until Harris' mortgage arrears were repaid. After the automatic stay was lifted and Harris' home was foreclosed, Viegelahn placed a hold on these funds rather than distributing them to Chase, which caused funds to accumulate. When Harris converted to Chapter 7, Viegelahn distributed the accumulated funds to other creditors, who would never have received them if they had been distributed to Chase as originally intended. Accordingly, if a right to these funds had vested specifically in Chase (the original intended recipient) when Harris made his payments to Viegelahn, the other creditors would have no right to them. Viegelahn's actual argument seems to be that the debtor's payment of funds to the trustee vests the class of creditors in general with a right to

payment. However, we find no support for such a rule in the Bankruptcy Code or in any legislative history.

Viegelahn also argues, based on 11 U.S.C. § 1327(a), that Harris "continues to be bound by the terms of the Chapter 13 plan[,] despite his election to convert to Chapter 7[,] with regard to payments made to the Trustee prior to conversion and not yet disbursed to creditors." Section 1327(a) states that "[t]he provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan." 11 U.S.C. § 1327(a). However, it is well settled that upon conversion to Chapter 7, "the chapter 13 plan and the order confirming that plan are no longer in force." *In re Doyle*, 11 B.R. 110, 111 (Bankr. E.D. Pa. 1981); *see also Michael II*, 699 F.3d at 313 ("Conversion to a Chapter 7 case necessarily ends the Chapter 13 case, which also terminates that Chapter 13 estate."). Because it is not generally true that the Chapter 13 plan "continues to bind" the parties after conversion, § 1327(a) does not establish that creditors have a continuing right to payment under the plan after conversion.

In holding that the debtor has a greater right than his creditors to undistributed funds held by the trustee at the time of conversion, the Third Circuit's opinion in *Michael II* relied heavily upon 11 U.S.C. § 1327(b), which states that "[e]xcept as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of

the estate in the debtor."[7] As the court explained:

> In the context of a Chapter 13 case, § 1327(b) vests all property of the Chapter 13 estate in the debtor on confirmation of the plan. Thus when the debtor transfers funds to the Chapter 13 trustee to fulfill its obligations under a confirmed plan (or, as here, wages are assigned directly to the Chapter 13 trustee under a garnishment order), the funds become part of the estate, and the debtor retains a vested interest in them. Though creditors have a right to those payments based on the confirmed plan, the debtor does not lose his vested interest until the trustee affirmatively transfers the funds to creditors.

Michael II, 699 F.3d at 313.

It is true that under §§ 1306(b) and 1327(b), a post-confirmation Chapter 13 debtor generally retains possession of, and a vested interest in, his property, including post-petition wages. However, *Michael II* errs by ignoring the clear exception to this general rule: "except as otherwise provided in the plan or the order confirming the plan." If the plan requires the debtor to make payments to the trustee

---

[7] Similarly, 11 U.S.C. § 1306(b) states that "[e]xcept as provided in a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate."

that will be distributed to creditors, the debtor certainly does not retain possession of these payments. Likewise, it would seem that the confirmation order specifically divests the debtor of any interest he may have in the payments made to the trustee. In the words of one bankruptcy court:

> When confirmed, the plan governs the relations of the parties and the debtor is bound to make the specified payments provided in the confirmed plan. These payments are specifically earmarked and set aside for distribution to creditors provided for by the confirmed plan. To the extent that the confirmed plan provides for payment from debtor's future earnings and the debtor actually makes payment to the trustee pursuant to that plan, the debtor is not entitled to possession nor is the debtor vested with title to such payments. Sections 1306(b) and 1327(b) specifically except such payments from their provisions since the debtor's right of possession and vesting of title is limited to all sums and property not otherwise provided for in the confirmed plan or confirmation order. These exceptions to possession and vesting of title in debtor indicate that debtor is to have no continuing interest in payments actually made pursuant to a confirmed plan.

Lennon, 65 B.R. at 136.[8]

The Third Circuit also reasoned that "absent anything to the contrary (and we know of nothing), by providing that a debtor who converts in bad faith is not entitled to this post-petition property, § 348(f)(2) logically requires that a debtor receive the property if he acts in good faith." *Michael II*, 699 F.3d at 313-14. The court went on to explain that "if a debtor does not act with bad faith in converting, logically the property should not go automatically to creditors; otherwise the penalty for a bad faith conversion would be diminished significantly." *Id.* at 315. This argument fails to recognize that undistributed post-petition wages paid to the trustee under the Chapter 13 plan constitute only a subset of the debtor's post-petition property. If the debtor is found to have converted in bad faith, *all* of the property he has acquired after filing will be included in the Chapter 7

---

[8] Viegelahn attempts to distinguish *Michael II* on the ground that the Chapter 13 plan in this case specifically provides that "[u]pon confirmation of the plan, all property of the estate *shall not vest in the Debtor(s)*, but shall remain as property of the estate subject to the automatic stay of 11 U.S.C. §362." (Emphasis added). However, the order confirming the plan also states that "[s]uch property as may revest in the Debtor shall so revest only upon further Order of the Court or upon dismissal, conversion, or discharge." We find it unnecessary to define with precision the property that "may revest in the Debtor." By requiring Harris to pay part of his wages to the trustee for distribution to creditors, the order clearly did not contemplate that such payments would revest in Harris.

estate and therefore be liquidated.[9] Accordingly, distributing the remaining payments held by the trustee at the time of conversion neither renders § 348(f)(2) superfluous nor removes the disincentive for bad faith in most cases.

III. Considerations of Policy and Equity

Because we find little guidance in the Bankruptcy Code as to whether undistributed funds held by the Chapter 13 trustee at the time of conversion should be returned to the debtor or distributed to creditors, we turn to considerations of equity and policy. When Congress enacted § 348(f) in 1994 to clarify that property acquired after filing a Chapter 13 petition would not pass into the Chapter 7 estate upon conversion absent bad faith, the House Report explained that "to hold otherwise would create a serious disincentive to chapter 13 filings." H.R. Rep. No. 103-835, at 57 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3366. Subsequent court opinions have interpreted this legislative history as reflecting a congressional policy of encouraging debtors to attempt repayment through Chapter 13 and removing disincentives that would discourage this. Both the district court in this case and the Third Circuit in *Michael II* placed great weight on this consideration. The district court noted "the

---

[9] Of course, it is possible that upon conversion, the debtor may no longer have in his possession any property acquired after filing the Chapter 13 petition; in that specific scenario, undistributed wages held by the trustee would constitute all of the debtor's remaining post-petition property.

Congressional policy of encouraging debtors to attempt a Chapter 13 bankruptcy—through which a debtor will pay his creditors at least as much and likely more than he would have under Chapter 7 — without penalty if that attempt fails." The district court further explained that "[h]olding that [the] Debtor is not entitled to the funds at issue in this case would create precisely the kind of disincentive to file a Chapter 13 bankruptcy that Congress was trying to avoid." *See also Michael II*, 699 F.3d at 314-16.

Bobroff, which was explicitly approved in the House Report, recognized that "[i]f debtors must take the risk that property acquired during the course of an attempt at repayment will have to be liquidated for the benefit of creditors if chapter 13 proves unavailing, the incentive to give chapter 13—which must be voluntary—a try will be greatly diminished." 766 F.2d at 803. This is certainly true; in *Lybrook*, which was explicitly repudiated in the House Report, the debtor inherited land worth $70,000 while his Chapter 13 plan was in place, and it was subsequently liquidated when he converted to Chapter 7. 951 F.2d at 137-38. Had he initially filed under Chapter 7 rather than attempting to repay his creditors through Chapter 13, he would have been able to keep the land. Accordingly, it is understandable that property acquired while proceeding under Chapter 13 should generally not pass into the Chapter 7 estate upon conversion. It is always possible that one might unexpectedly acquire some valuable asset, and if the rule were otherwise, proceeding under Chapter 13 would court the risk

that any such asset could be lost through liquidation – an obvious disincentive.

On the other hand, it is unlikely that a debtor would be meaningfully deterred by the knowledge that payments made under a confirmed Chapter 13 plan will not be returned to him if he chooses to convert to Chapter 7. As one court explained, such a rule "will not discourage any individuals from proceeding in Chapter 13, since it simply requires them to fully honor their obligation under a confirmed plan up to the point when they voluntarily wish to terminate the provisions of the plan and have their case dismissed or converted to a Chapter 7 case." *Bell*, 248 B.R. at 240. Similarly, we fail to perceive how such a rule "penalize[s]" a debtor for attempting Chapter 13. *Boggs*, 137 B.R. at 411. It is the debtor who proposes the payment plan in the first place, with the explicit provision that the funds are to be used to pay creditors. Because the funds are out of the hands of the debtor after payment and under the control of the trustee, it is essentially fortuitous whether any undistributed funds are still in the hands of the trustee at the time of conversion.[10] And "if the undistributed funds revert to [the debtor], instead of being distributed to the creditors in accordance with the plan's terms, [the debtor] would

---

[10] If undistributed funds are returned to the debtor, both the creditors' right to receive the payments and the debtor's chance of having funds returned would be dependent on the trustee's speed in distributing the payments. *See Waugh*, 82 B.R. at 400.

receive a windfall." *Michael II*, 699 F.3d at 320 (Roth, J., dissenting). Of course, because the debtor can choose to convert to Chapter 7 at any time and thereby avoid making any further payments under the Chapter 13 plan, he retains the power to prevent any additional wages from going into the hands of creditors.

As suggested above, wages paid to the trustee pursuant to the Chapter 13 plan should be distinguished from the debtor's other property acquired after the date of filing. The dissenting opinion in *Michael II* explains this distinction:

> I agree that [§ 348(f)] described what became of property or rights to property acquired by the debtor during the pendency of the Chapter 13 proceedings. I have no argument against this interpretation. Mr. Bobroff keeps his potential tort recovery and Mr. Lybrook keeps the farm land inherited from his father because the tort recovery and the farmland inheritance were not property of the estate as of the date of the filing of the petition. To the extent that Michael's wages were not attached, the amendment also covered these unattached wages earned during the course of the Chapter 13 bankruptcy . . . .
>
> However, we are not dealing simply with wages here but with that portion of the wages that had been attached under the plan and paid to the trustee for

> distribution to the creditors. I maintain that there is a crucial difference.[11]

Michael II, 699 F.3d at 319 (Roth, J., dissenting). We conclude that returning undistributed funds to the debtor is not justified by the policy of encouraging debtors to proceed through Chapter 13 rather than Chapter 7.

Additionally, distribution of the funds to creditors is supported by strong considerations of fairness. As the dissenting opinion in *Michael II* explained, "the debtor makes payments in order to fulfill his obligations under the reorganization plan and in exchange for the benefits he derives from the plan." *Michael II*, 699 F.3d at 320 (Roth, J., dissenting). Or, in other words, "the attached wages are the *quid pro quo* that the debtor has given up during the pendency of the reorganization in return for being permitted to stave off foreclosure and cure the mortgage default, retain the use of his

---

[11] The next sentence is: "It is my position that, although the debtor's unattached wages earned during the reorganization period will not be included in the Chapter 7 estate, the attached wages that have been paid to the trustee pursuant to the plan should be." *Michael II*, 699 F.3d at 319 (Roth, J., dissenting). This last clause appears to be an error; elsewhere, the dissent argues not that these funds should be included in the Chapter 7 estate, but that they should be distributed by the Chapter 13 trustee pursuant to the confirmed plan.

automobile, and enjoy the automatic stay." *Id.*[12] Generally,

> [t]he benefits of proceeding in Chapter 13 for any given debtor are numerous and varied, including, but not limited to obtaining a 'super discharge,' saving a residence from foreclosure, avoiding a substantial abuse dismissal, cramming down secured assets, and having the benefit of the automatic stay for an extended period of time.

Bell, 248 B.R. at 239 n.3.

"Conversion does not retroactively alter this arrangement and undo the benefits the debtor received from the plan." *Michael II*, 699 F.3d at 320 n.8 (Roth, J., dissenting). Moreover, conversion does not undo the disadvantages that creditors may have suffered as a result of the plan, such as depreciation of secured property. As one court explained:

> The Court would also observe that in the case at bar and prior to conversion, the Debtors retained possession of and continued to use certain property that was security for certain of their debts.

---

[12] We note that in this case, Harris agreed to give up his automobile to satisfy a debt greater than the value of the automobile.

> This is typical of most chapter 13 cases. The security normally consists of such items as automobiles, homes and household goods and furnishings. The secured lenders are prohibited from taking possession of their property because the debtor has a confirmed plan which proposes to pay them each month. It appears to this Court to be patently unfair to allow a debtor to drive and depreciate an automobile, occupy a home or use household goods based on a promise to his creditors in the form of a court approved plan, and then allow the debtor to snatch away the monies which the trustee is holding to make the payments, but has not yet disbursed, by allowing the debtor to pick an opportune time to convert.

O'Quinn, 143 B.R. at 413. Although, as discussed above, payments made under the plan do not give creditors any vested rights to payment, we conclude that the creditors' claim to the undistributed funds is superior to that of the debtor.

CONCLUSION

For the reasons explained above, we REVERSE the district court's order and REMAND for further proceedings consistent with this opinion.

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

In re:	§	
	§	
CHARLES E. HARRIS III,	§	Cv. No.
	§	SA:12-CV-00540-DAE
Debtor.	§	Bankr. No.
	§	10-50655-lmc
	§	
MARY K. VIEGELAHN, Chapter 13 Trustee,	§	
	§	
Appellant,	§	
	§	
vs.	§	
	§	
CHARLES E. HARRIS III,	§	
	§	
Appellee.	§	

MEMORANDUM OPINION AND ORDER AFFIRMING BANKRUPTCY COURT'S ORDER COMPELLING RETURN OF FUNDS

Appellant Mary K. Viegelahn, Chapter 13 Trustee ("the Trustee"), appeals the February 29, 2012 Order Compelling Return of Funds issued by the United States Bankruptcy Court for the Western District of Texas. (Doc. # 1-4 Ex. 4.)[1] The Bankruptcy

[1] Except where otherwise noted, all citations are to the docket in Cv. No. SA:12-CV-00540-DAE.

Court's Order granted debtor Charles E. Harris III's motion to compel the Trustee to turn over undistributed funds collected pursuant to a confirmed Chapter 13 plan in a case that was later converted to Chapter 7. Having considered the record and the parties' briefs, the Court, for the reasons below, **AFFIRMS** the Order of the Bankruptcy Court.

BACKGROUND

On February 24, 2010, Charles E. Harris III ("Debtor") filed a voluntary petition for relief under Chapter 13 of the United States Bankruptcy Code. (Doc. # 1-4 Ex. 6 ¶ II.) His plan of reorganization, which was confirmed on April 15, 2010, called for him to pay the Trustee, for distribution to various creditors, $530.00 per month for 60 months. (Doc. # 1-4 Ex. 11.)

In November of 2010, after Debtor fell behind on his mortgage (doc. # 9 at 3), the Bankruptcy Court lifted the automatic stay preventing Chase the Home Finance from foreclosing on Debtor's Residence.[2] (Bankr. Case No. 10-50655-lmc [hereinafter Bankr. Case], doc. # 28.) Debtor moved out of his home and into a rental but continued to make payments to the Trustee pursuant to the pay order. (Doc. # 9 at 3.) In light of the foreclosure, the Trustee placed a hold on funds designated for the mortgage under the plan,

---

[2] The Bankruptcy Code's automatic stay, which takes effect immediately upon the filing of a bankruptcy petition, helps ensure the orderly distribution of assets by temporarily protecting the property of the debtor's estate from the reach of creditors. *See* 11 U.S.C. § 362(h).

and funds began to accumulate in the Trustee's account. (Doc. # 6 at 11.)

On November 21, 2011, Debtor, having determined that he could no longer afford the plan payments, filed a Notice of Voluntary Conversion that converted his case from a Chapter 13 reorganization of debts to a Chapter 7 liquidation. (Bankr. Case, doc. # 30.) At that time, the Trustee had $5,519.22 that she had received from Debtor but had not distributed to creditors. (Doc. # 6 at 11.)

Around the same time, Debtor's attorney sent an email to the Trustee requesting to be paid $1,200.00 in attorney's fees out of the funds that the Trustee had received from Debtor. (Doc. # 1-4 Ex. 6 ¶ III.) The Trustee disbursed the requested amount to Debtor's attorney on or about November 22, 2011, leaving $4,319.22 in Debtor's account. (*Id.*)

On or about December 1, 2011—ten days after Debtor converted his case to Chapter 7—the Trustee distributed the remaining funds to several of Debtor's creditors in accordance with the former Chapter 13 plan. (*Id.*) On or about December 12, 2011, Debtor's attorney requested that those funds be refunded to Debtor. (*Id.* ¶ IV.) The Trustee refused, claiming she was required to distribute to creditors any funds received before the case was converted to Chapter 7. (*Id.*)

On December 29, 2011, Debtor, who had expected to receive the money held by the Trustee to cover his ongoing personal expenses, filed a Motion to Compel Return of Funds. (Doc. # 1-4 Ex. 6.) The Bankruptcy Court granted Debtor's Motion on

February 29, 2012, ordering the Trustee to pay Debtor $4,319.22. (*Id.* Ex. 4.) On March 5, 2012, the Trustee timely appealed the Bankruptcy Court's Order to this Court pursuant to 28 U.S.C. § 158(a). (*Id.* Ex. 3.)

The Trustee submitted the following issues for appeal:

1. Did the Bankruptcy Court commit error by finding that the Chapter 13 Trustee is not duly authorized to disburse funds to a debtor's creditors post-conversion that were received by the Trustee from the debtor prior to conversion?

2. Do undistributed payments to the Chapter 13 Trustee made by the debtor post-confirmation but pre-conversion re-vest in the debtor, or do such payments remain subject to disbursement to creditors by the Chapter 13 Trustee pursuant to a confirmed plan?

3. Does 11 U.S.C. § 348(e) prohibit a Chapter 13 Trustee from disbursing to creditors, pursuant to a confirmed plan, payments made by the debtor to the Chapter 13 Trustee prior to conversion to Chapter 7?

4. Does 11 U.S.C. § 1326(a)(2)—which states: "[A] payment made under this subsection shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in

accordance with the plan as soon as is practicable. If a plan is not confirmed, the trustee shall return any such payment to the debtor after deducting any unpaid claim under § 503(b) of this title"—vest rights in the creditors such that a Chapter 13 Trustee must disburse to creditors plan payments made by the debtor to the Trustee post-confirmation but pre-conversion?

5. Does 11 U.S.C. § 1327, which provides that a confirmed plan binds the debtor and each creditor, allow the Chapter 13 Trustee to disburse to creditors payments made by the debtor to the Chapter 13 Trustee post-confirmation but prior to conversion to Chapter 7?

(Doc. # 1-4 Ex. 1.) These five issues all present essentially the same question: Was the Trustee required to distribute the funds in her possession at the time of conversion to Debtor or to his creditors?

STANDARD OF REVIEW

A district court reviews a bankruptcy court's findings of fact for clear error. *In re Kennard*, 970 F.2d 1455, 1457–58 (5th Cir. 1992) (citing *In re Multiponics, Inc.*, 622 F.2d 709, 713 (5th Cir. 1980)); Fed. R. Bankr. P. 8013. Conclusions of law are reviewed de novo. *Id.* at 1458; *In re Stembridge*, 394 F.3d 383, 385 (5th Cir. 2004).

DISCUSSION

This appeal raises a question on which the Fifth Circuit has yet to rule involving the interpretation of Chapter 13 of the Bankruptcy Code, 11 U.S.C. §§ 101–1532 (2005) ("the Code"): If, at the time of conversion from a Chapter 13 reorganization of debts to a Chapter 7 liquidation, the Trustee possesses funds collected pursuant to a confirmed Chapter 13 reorganization plan, must the Trustee return those funds to the debtor or distribute them to creditors in accordance with the plan? The Third Circuit is the only court of appeals that has directly addressed this issue; it concluded that the funds in question must be returned to the debtor. *See In re Michael*, 699 F.3d 305, 317 (3d Cir. 2012).

Because this is a pure question of law, the Court reviews the Bankruptcy Court's conclusion de novo. For the reasons that follow, this Court agrees with the Third Circuit's reasoning and concludes that the Trustee was required to return the funds to Debtor.

I. Bankruptcies Under Chapters 7 and 13

The Court begins with a brief overview of bankruptcies under Chapters 7 and 13 of the Code and conversions from Chapter 13 to Chapter 7.

A. Chapter 7 Liquidations

A Chapter 7 bankruptcy is also known as a "straight bankruptcy" or liquidation and is generally available only to debtors who meet certain low-income requirements. *See* 11 U.S.C. § 707(b)(2)(A); *In*

re Hill, 328 B.R. 490, 497 (Bankr. S.D. Tex. 2005) (holding that debtors with combined monthly income of more than $13,600.00 were "not needy debtors entitled to relief under chapter 7"). Filing a Chapter 7 petition automatically creates an "estate" comprised of all of a debtor's legal and equitable interests in property as of the filing date. 11 U.S.C. §§ 301(a), 541. Subject to certain exceptions, *see id.* § 541(a), property acquired after filing for Chapter 7 bankruptcy is not included in the estate.

An impartial trustee is appointed to administer the estate, *id.* § 701, selling the debtor's nonexempt assets and using the proceeds to pay creditors in accordance with the provisions of the Code, *id.* §§ 704, 726. With certain exceptions, *see id.* § 523, the remaining debts are then fully discharged, *id.* § 727. However, a bankruptcy court may refuse to grant discharge in certain circumstances, such as in cases of fraud, *id.* § 727(a)(4); where the debtor has filed for Chapter 7 relief within the previous eight years, *id.* § 727(a)(8); or where the court determines that granting relief would be "an abuse of the provisions of [Chapter 7]," *id.* § 707.

B. Chapter 13 Debt Reorganizations

While Chapter 7 uses liquidation to satisfy existing debt, Chapter 13 looks to future income. Also known as a "wage earner's plan," Chapter 13 enables individuals with regular income to develop a plan to repay all or part of their debts over a three- to five-year period. *Id.* § 1322(d). In order to be confirmed by the bankruptcy court, a Chapter 13 plan must provide for creditors to receive at least as much as they would have in a Chapter 7 liquidation.

Id. § 1325(a)(4). As under Chapter 7, an impartial trustee administers the case, collecting payments from the debtor and making distributions to creditors. *Id.* § 1302(b). The Chapter 13 bankruptcy tends to be favored by debtors who have fallen behind on secured loan payments, such as mortgages and car loans, since it enables the debtor to maintain possession of the property while catching up on payments through a court-approved repayment plan. *See id.* § 362.

The estate created upon filing a Chapter 13 petition is not the same as a Chapter 7 estate. While a Chapter 7 estate is, roughly speaking, a "snapshot" of the debtor's assets at the time of filing, the Chapter 13 estate includes both "the property specified in § 541" that exists at the time of filing and "all property of the kind specified in [§ 541] that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first . . . ." *Id.* § 1306(a) (emphasis added). This includes "earnings from services performed by the debtor after the commencement of the case," *id.* § 1306(b), which is why a Chapter 13 plan is ordinarily funded by the debtor's future income.

A debtor must begin making payments to the Chapter 13 trustee within 30 days of the filing of the plan or an order for relief, whichever is earlier. *Id.* § 1326(a)(1). The trustee must retain these payments "until confirmation or denial of confirmation [of the plan]." *Id.* § 1326(a)(2). Confirmation of the plan (1) vests all property of the estate in the debtor (except

as otherwise provided), *id.* § 1327(b); (2) binds the debtor and its creditors, *id.* § 1327(a); and (3) obligates the trustee to distribute the debtor's payments under the plan to creditors, *id.* § 1326(a)(2), (c). "If a plan is not confirmed," however, "the trustee shall return any such payments not previously paid . . . to the debtor, after deducting any unpaid claim allowed under section 503(b)." *Id.* § 1326(a)(2).

C. Conversion from Chapter 13 to Chapter 7

At any time during the Chapter 13 proceeding, even following confirmation of the plan, a debtor may convert his case to a Chapter 7 liquidation. 11 U.S.C. § 1307(a). Conversion "does not effect a change in the date of filing of the petition." *Id.* § 348(a). In other words, when a case is converted from Chapter 13 to Chapter 7, the order converting the case is effectively backdated to the date on which the Chapter 13 petition was filed. Accordingly, the Code provides that "property of the estate in the converted [Chapter 7] case shall consist of property of the estate, as of the date of filing of the [Chapter 13] petition, that remains in the possession of or is under the control of the debtor on the date of conversion." *Id.* § 348(f)(1)(A) (emphasis added). Where the conversion was in bad faith, however, section 348(f)(2) provides that "the property of the estate in the converted case shall consist of the property as of the date of conversion." *Id.* § 348(f)(2) (emphasis added).

II. Did Plan Confirmation Vest in Debtor's Creditors a Right to the Funds?

The funds at issue in this case were garnished from Debtor's wages during the time after confirmation of his Chapter 13 plan but before conversion of his case to Chapter 7. (Doc. # 6 at 11.) Accordingly, there is no dispute that these funds were not "property of the estate . . . as of the date of filing of the [Chapter 13] petition . . . ." 11 U.S.C. § 348(f)(1)(A). A plain reading of § 348(f)(1)(A) would seem to establish, therefore, that the funds should not be considered part of the Chapter 7 estate in the absence of a bad-faith conversion. *See* § 348(f)(2). And if the funds are not part of the Chapter 7 estate, argues Debtor, they should be returned to him upon conversion. (Doc. # 9 at 7.).

In support of this argument, Debtor points to the Fifth Circuit's decision in *Stamm v. Morton (In re Stamm)*, 222 F.3d 216 (5th Cir. 2000). (Doc. # 9 at 5–7.) In *Stamm*, debtors filed a Chapter 13 petition and began making payments to the trustee. *Id.* at 216. When they were "unable to confirm a [Chapter 13] plan," however, the debtors converted their case to Chapter 7. *Id.* Upon conversion, the Chapter 13 trustee distributed to the Chapter 7 trustee the payments the debtors had made while awaiting confirmation. *Id.* The Chapter 7 trustee filed a Motion for Determination of whether the funds were property of the Chapter 7 estate, and both the bankruptcy court and the district court held that they were. *Id.* at 216–17.

The Fifth Circuit reversed, basing its decision on the 1994 amendments to § 348. *Id.* at 218. The court noted that Congress, as part of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 311, 108 Stat. 4106, 4137-38, had amended § 348 to resolve a circuit split on the issue of whether post-petition Chapter 13 income remained property of the estate upon conversion to Chapter 7. *Id.* at 217 (citing *Baker v. Rank (In re Baker)*, 154 F.3d 534, 536 (5th Cir. 1998) (discussing the split and noting that the issue was confusing because it involved the interplay of several Code provisions—§ 541, § 1306, and § 348)); *see also In re Bobroff*, 766 F.2d 797, 803–04 (3d Cir. 1985) (holding that post-petition income does not remain property of the estate); *In re Lybrook*, 951 F.2d 136, 138 (7th Cir. 1991) (holding that post-petition income remains property of the estate); *In re Lindberg*, 735 F.2d 1087, 1089–90 (8th Cir. 1984) (same). Looking to the legislative history of § 348, the *Stamm* court concluded that Congress meant to clarify that "[d]ebtors' wages, earned after the filing of their Chapter 13 petition and before discharge under Chapter 7, are not part of the Chapter 7 estate." *Id.* at 218. Accordingly, the *Stamm* court ordered that the payments the debtors had made prior to conversion be returned to them. *Id.*

The Trustee "does not dispute that post [-]petition wages are not property of a Chapter 7 estate." (Doc. # 10 at 4.) However, she insists that funds collected under a confirmed plan "belong to the Chapter 13 estate" (*id.* at 8 (emphasis added)), not to Debtor. Confirmation of a plan, asserts the Trustee, vests certain rights in the creditors. It creates an irrevocable trust in the funds the Trustee collects,

and the Trustee has no choice but to distribute those funds according to the plan. (Doc. # 6 at 16.) Accordingly, the Trustee insists that *Stamm* is distinguishable from this case since the Chapter 13 plan in that case had not been confirmed prior to conversion. (*Id.* at 3; *see also In re Stamm*, 222 F.3d at 217 (stating that the funds at issue were "post-commencement pre-confirmation wages paid to the Chapter 13 Trustee").)

The Trustee bases her argument on § 1326 and § 1327 of the Code. Section 1326 provides that "[i]f a [Chapter 13] plan is confirmed, the trustee shall distribute any such payment in accordance with the plan as soon as is practicable" and that "[i]f a plan is not confirmed, the trustee shall return any such payments not previously paid and not yet due and owing to creditors . . . to the debtor . . . ." 11 U.S.C. § 1326 (emphases added). Pointing to the mandatory language of this section, the Trustee argues that she had no choice but to distribute any funds she received from Debtor pursuant to his confirmed plan. (Doc. # 6 at 17.)

Although § 348(e) states that "[c]onversion of a case . . . terminates the service of any trustee or examiner that is serving in the case before such conversion," the Trustee argues that this section does not operate to prevent a trustee from disbursing funds in her possession at the time of conversion. (*Id.* at 15.) She points out that a trustee's services clearly do not terminate immediately upon conversion since she is required to wind up the administration of the Chapter 13 estate by turning over to the Chapter 7 trustee the records and property of the estate in her

possession, *see* Fed. R. Bankr. P. 1019(4), and by filing a final report and account, *see* Fed. R. Bankr. P. 1019(5)(B)(ii). (Doc. # 6 at 15.) Because § 1326(a)(2) states that a trustee "shall" distribute funds received according to a confirmed plan, argues the Trustee, § 348 does not relieve a Chapter 13 trustee of the duty to disburse to creditors monies received post-confirmation and pre-conversion. (*Id.* at 16.)

A number of courts, mostly in decisions written before the addition of § 348(f), have agreed with the Trustee's argument. In *In re Waugh*, for example, the Bankruptcy Court for the Western District of Pennsylvania held that "[t]he word 'shall' in section 1326(a)(2) creates the condition of a trust" and that "[c]reditors have the right to the funds in an active confirmed chapter 13 plan upon payment by the debtor." 82 B.R. 394, 300 (Bankr. W.D. Pa. 1988); see also *In re Milledge*, 94 B.R. 218, 220 (Bankr. M.D. Ga. 1988) (same). Similarly, the bankruptcy court in In re Galloway held that after a debtor "voluntarily part[s] with wages and deliver[s] them to the custody of a trustee in performance of a confirmed Chapter 13 plan, the creditors have a vested right to receive those payments pursuant to the plan." 134 B.R. 602, 603 (Bankr. W.D. Ky. 1991); *see also In re Halpenny*, 125 B.R. 814 (Bankr. D. Haw. 1991) (same).

Central to these courts' holdings is the idea that a confirmed plan requires creditors to forgo certain rights in exchange for the debtor's promise to make payments under the plan. Under a confirmed plan, for example, creditors might be prevented from foreclosing on the debtor's home or repossessing his automobile, being forced to settle instead for the

debtor's promise to pay them back over time. As the Bankruptcy Court for the Southern District of Mississippi put it:

> It appears to this Court to be patently unfair to allow a debtor to drive and depreciate an automobile, occupy a home or use household goods based on a promise to his creditors in the form of a court approved plan, and then allow the debtor to snatch away the monies which the trustee is holding to make the payments, but has not yet disbursed, by allowing the debtor to pick an opportune time to convert.

In re O'Quinn, 143 B.R. 408, 413 (1992). By permitting Debtor to recoup the funds at issue, insists the Trustee, the Bankruptcy Court's decision "essentially allows a debtor to convert undistributed funds . . . into [his] savings account"; and this will force trustees, "in an attempt to avoid such a windfall to [debtors], to make distributions to creditors on a daily basis," which the Trustee argues is impractical. (Doc. # 6 at 24.)

Finally, these courts point to § 1326(a)(2)'s language requiring the Chapter 13 trustee to return any undistributed funds to the debtor <u>if a plan is not confirmed</u>. "Read alone," admitted the Third Circuit in *In re Michael*,

> this section arguably indicates that if a plan is not confirmed the trustee must return accumulated funds to the debtor, and that if a plan is confirmed the trustee, by implication stemming from the absence of similar

> language, is required to distribute accumulated funds to creditors as provided by the plan. That is, if Congress intended for undistributed funds held by the trustee post-confirmation to be returned to a debtor, it could have included similar language regarding post-confirmation payments in § 1326(a)(2).

699 F.3d at 311 (emphases added); *see also In re Galloway*, 134 B.R. at 603 (holding that from the language of § 1326 "[i]t is clear that the trustee shall return undistributed payments if the plan is not confirmed" and that "[t]he code is just as specific that if plan payments are made, pursuant to a confirmed plan, then the trustee shall distribute any such payments in accordance with the plan").

While the Trustee's arguments have appeal, the Court finds more persuasive the reasoning of those courts—including, most recently, the Third Circuit—that have concluded that post-confirmation, pre-conversion funds in a trustee's possession should be returned to the debtor. These courts focus on the Congressional policy of encouraging debtors to attempt a Chapter 13 bankruptcy—through which a debtor will pay his creditors at least as much and likely more than he would have under Chapter 7—without penalty if that attempt fails. *See, e.g., In re Boggs*, 137 B.R. 408, 411 (Bankr. W.D. Wash. 1992) ("[T]he Congressional policy of encouraging debtors to repay their creditors via Chapter 13 is furthered by debtors (and their counsel) knowing they will not be penalized for attempting Chapter 13."); *In re Peters*, 44 B.R. 68, 71 (Bankr. M.D. Tenn. 1984) ("Since [§ 348] treats the date of commencement of the

Chapter 13 case as the date of commencement of the Chapter 7 case after conversion, the debtor is not penalized for originally pursuing a Chapter 13 case instead of a Chapter 7 case."); *In re Bullock*, 41 B.R. 637, 640 (Bankr. E.D. Pa. 1984) ("[T]he case is deemed to have been filed as a chapter 7 proceeding and that portion of the debtor's postpetition wages, which were deducted from his salary, were deposited in the chapter 7 estate although they were not properly includable therein . . . . Since the deducted wages were not part of the chapter 7 estate, the debtor is entitled to recover such wages in full . . . .").

This Court agrees that Congressional policy should guide the interpretation of these ambiguous Code provisions. Chapter 13 was intended to "encourage more debtors to repay their debts over an extended period rather than to opt for straight bankruptcy liquidation and discharge." H.R. Rep. No. 95-595 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 5966, 1977 WL 9628. "In return for a debtor's resolve to commit more of his assets to the repayment of his creditors than would be required under a Chapter 7 liquidation, Chapter 13 of the Bankruptcy Code provides the debtor with a number of benefits unavailable under Chapter 7," such as the ability to retain his property and to better protect his credit rating. *In re Peters*, 44 B.R. 68, 71 (Bankr. M.D. Tenn. 1984); *see also In re Lennon*, 65 B.R. 130, 132 (Bankr. N.D. Ga. 1986) ("The statutory scheme of the Bankruptcy Code reflects a congressional intent to make attractive and encourage greater use, which must be voluntary, of Chapter 13 rehabilitation and creditor payment, rather than Chapter 7 liquidation with little or no creditor payment.").

Congress, in the section-by-section analysis accompanying the Bankruptcy Reform Act of 1994, included the following illustration of the "serious disincentive to file chapter 13 filings" that it hoped § 348(f) would eliminate:

> [A] debtor who had $10,000 equity in a home at the beginning of the case, in a State with a $10,000 homestead exemption, would have to be counseled concerning the risk that after he or she paid off a $10,000 second mortgage in the chapter 13 case, creating $10,000 in equity, there would be a risk that the home could be lost if the case were converted to chapter 7 (which can occur involuntarily). If all of the debtor's property at the time of conversion is the property of the chapter 7 estate, the trustee would sell the home . . . to realize the $10,000 in equity for the unsecured creditors and the debtor would lose the home.

In re Michael, 699 F.3d at 314 (quoting H.R. Rep. No. 103-835, reprinted in 1994 U.S.C.C.A.N. 3340, 3366, 1994 WL 562232); *see also Bobroff*, 766 F.2d at 803 ("If debtors must take the risk that property acquired during the course of an attempt at repayment will have to be liquidated for the benefit of creditors if chapter 13 proves unavailing, the incentive to give chapter 13—which must be voluntary—a try will be greatly diminished."). It seems clear, therefore, that distributing the funds in question to Debtor's creditors would contravene Congressional policy.

Those courts holding that undistributed pre-conversion payments must be returned to the debtor reason that there is nothing unfair about returning those funds to a debtor rather than to his creditors. *See, e.g., In re Boggs*, 137 B.R. at 410 ("Th[e] creditors have had the benefit of distribution from debtors' wage contributions, which would not have been available to them under Chapter 7. In all, there seems no inherent inequity in refunding undisbursed wage contributions to debtors on conversion."). This Court agrees. By attempting a Chapter 13 bankruptcy, a debtor attempts to pay his creditors more than they would have received under a Chapter 7 liquidation. When Chapter 13 plan does not work out and a debtor exercises his right to convert to Chapter 7, "no reason of policy suggests itself why the creditors should not be put back in precisely the same position as they would have been had the debtor never sought to repay his debts by filing under Chapter 13." *In re Hannan*, 24 B.R. 691, 692 (Bankr. E.D.N.Y.). Moreover, as the Third Circuit recently noted, "no provision in the Bankruptcy Code classifies any property, including post-petition wages, as belonging to creditors." *In re Michael*, 699 F.3d at 312–13. That court explained:

> When the debtor transfers funds to the Chapter 13 trustee . . . under a confirmed plan . . . the funds become part of the estate, and the debtor retains a vested interest in them. Though creditors have a right to those payments based on the confirmed plan, the debtor does not lose his vested interest until the trustee affirmatively transfers the funds to creditors. Also, § 1326(a)(2) and (c) only

> address the obligation of the trustee to distribute payments in accordance with a confirmed plan; they do not vest creditors with any property rights.

Id. at 313. Instead, conversion from Chapter 13 to Chapter 7 "necessarily ends the Chapter 13 case, which also terminates that Chapter 13 estate." *Id.*

Of course, the Court realizes that this interpretation of the Code might incentivize bad-faith conversions—that debtors with no intention of fully repaying their creditors under a Chapter 13 plan might file a Chapter 13 petition, take advantage of the automatic stays and other benefits, and then convert to a Chapter 7 liquidation at an opportune time. However, Congress recognized this danger, too; and that, presumably, is why it drafted § 348(f)(2) to provide that "[i]f the debtor converts a case . . . in bad faith, the property of the estate in the converted case shall consist of the property as of the date of conversion." *Id.* (emphasis added). Thus, if a court determines that a debtor is attempting to "game the system," it may "punish" him by determining the Chapter 7 estate at the time of conversion instead of at the time that he filed a petition under Chapter 13. Moreover, the fact that Congress included a bad-faith exception provides additional support for the idea that Congress would want the disputed funds to be returned to Debtor. As the Third Circuit explained, "by providing that a debtor who converts in bad faith is not entitled to this post-petition property, § 348(f)(2) logically requires that a debtor receive the property if he acts in good faith." *In re Michael*, 699 F.3d at 314.

Holding that Debtor is not entitled to the funds at issue in this case would create precisely the kind of disincentive to file a Chapter 13 bankruptcy that Congress was trying to avoid. Here, Debtor attempted to repay his debts under Chapter 13, making payments under the confirmed plan for over a year and a half. (Doc. # 6 at 11.) There is no dispute that the funds at issue would not have been part of the Chapter 7 estate if Debtor had filed a Chapter 7 petition originally; nor does the Trustee allege that Debtor converted to Chapter 7 in bad faith. Thus, for the reasons given above, the Court agrees with the Third Circuit's recent decision in *In re Michael*, 699 F.3d 305 (3d Cir. 2012), and concludes that the Congressional policy favoring Chapter 13 over Chapter 7 requires that the funds at issue be returned to Debtor.

To explicitly address each of the issues presented for appeal, the Court hereby holds (1) that the Bankruptcy Court did not err in finding that a Chapter 13 trustee is not authorized to disburse to creditors, after conversion to Chapter 7, undistributed funds received prior to conversion; (2) that undistributed payments to a Chapter 13 trustee made after confirmation of a Chapter 13 plan but before conversion to Chapter 7 re-vest in the debtor upon conversion; (3) that 11 U.S.C. § 348(e) prohibits a Chapter 13 trustee from disbursing, after conversion to Chapter 7, plan payments made by the debtor prior to conversion; (4) that 11 U.S.C. § 1326(a)(2) does not vest rights in creditors that would require a Chapter 13 trustee to disburse funds to them after conversion to Chapter 7; and (5) that 11

U.S.C. § 1327 does not permit a Chapter 13 trustee to disburse to creditors, after conversion to Chapter 7, funds paid by the debtor to the trustee pursuant to a confirmed Chapter 13 plan.

The Court recognizes that a practical consequence of this holding is that "creditors will request more frequent distributions from the Chapter 13 trustee." *In re Michael*, 699 F.3d at 317. This may be inconvenient to trustees, since the most efficient manner of administering payments may be to accumulate them and distribute them to creditors at an established time. However, the Court concludes that the increased administrative burden, if any, is outweighed by the clearly expressed Congressional policy of encouraging debtors to attempt a Chapter 13 repayment plan over a Chapter 7 liquidation. Moreover, if a court finds that a debtor is attempting to "game the system," section 348(f)(2)'s bad-faith provision authorizes that court to punish such behavior by determining the Chapter 7 estate as of the date of conversion.

CONCLUSION

For the reasons given, the Court **AFFIRMS** the Bankruptcy Court's February 29, 2012 Order Compelling Return of Funds.

IT IS SO ORDERED.

DATED: San Antonio, Texas, March 22, 2013.

/s/
David Alan Ezra
Senior United States District Judge

SO ORDERED.

SIGNED this 29th day of February, 2012.

/s/
LEIF M. CLARK
UNITED STATES
BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

IN RE:	§	CASE NO: 10-50655C
Charles E. Harris, III	§	
DEBTOR(S)	§	CHAPTER 7

ORDER COMPELLING RETURN OF FUNDS

Upon motion of Debtor and upon the representations contained therein and evidence presented, the Court finds and therefore, it is

ORDERED that the Chapter 13 Trustee, Mary K. Viegelahn, shall pay $4,319.22 to Charles E. Harris, III.

###

THIS ORDER WAS PREPARED AND SUBMITTED BY:

MALAISE LAW FIRM
909 NE Loop 410, Suite 300
San Antonio, Texas 78209
Telephone: (210) 732-6699
Telecopier: (210) 732-5826

Approved as to Form:

/s/
Steven G. Cennamo

Chapter 13 Trustee –
Mark K. Viegelahn
909 NE Loop 410, Suite 400
San Antonio, TX 78209

Vanessa G. Guerrero